Treasury Decision 8476, 26 CFR, IRC Sec(s). 42

June 18, 1993

FULL TEXT:

AGENCY:

Internal Revenue Service, Treasury.

ACTION:

Final regulations.

SUMMARY:

This document contains final regulations on the arbitrage and related restrictions applicable to tax-exempt bonds issued by State and local governments. Changes to the applicable law were made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Revenue Reconciliation Act of 1989, and the Revenue Reconciliation Act of 1990. These regulations affect issuers of tax-exempt bonds and provide guidance for complying with the arbitrage and related restrictions.

DATES:

These regulations are effective on July 1, 1993.

For dates of applicability of these regulations to various bond issues, including certain elective retroactivity provisions and transition rules, see §1.148-11 of these regulations.

FOR FURTHER INFORMATION CONTACT:

Scott R. Lilienthal or William P. Cejudo at 202-622-3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1347.

The estimated annual burden per recordkeeper varies from 12 hours to 15 hours, depending on individual circumstances, with an estimated average of 13.5 hours.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require more or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

Explanation of Provisions

I. Background of Regulations

Section 148 provides rules restricting the use of proceeds of tax-exempt State and local bonds to acquire higher yielding investments. Section 148(a) provides generally that interest on a State or local bond is tax-exempt only if the issuer invests bond proceeds at a yield that is not materially higher than the yield on the bond issue. Section 148(f) provides that interest on a State or local bond is tax-exempt only if the issuer rebates to the Federal government certain arbitrage earnings derived from investing gross proceeds at a yield exceeding the yield on the bond issue.

Longstanding regulations relating to the arbitrage yield restriction rules are in §§1.103-13 through 1.103-15. On May 18, 1992, final regulations under section 148 were published at §§1.148-0 through 1.148-11 (the May 1992 regulations). At that time, the Internal Revenue Service and the Treasury Department announced that they would further simplify and clarify the regulations under section 148 by revising the arbitrage regulations and finalizing these rewritten regulations by June 1993. To evidence this commitment, the May 1992 regulations expire on June 30, 1993.

Proposed regulations were published at §§1.148-0 through 1.148-11, 1.149(d)-1, 1.149(g)-1, 1.150-1, and 1.150-2 in the Federal Register for November 6, 1992. The proposed regulations would replace the existing yield restriction and rebate regulations currently provided in §§1.103-13 through 1.103-15, §1.103-13T, §§1.148-0 through 1.148-11, §1.148-12T, and §1.148-13T with coordinated, simplified regulations. The proposed regulations also propose to amend certain related regulations on advance refunding limitations in §1.149-1(d), definitions in §1.150-1, and reimbursement bonds in §1.103-18. Written comments were received on the proposed regulations, and additional public comments were received at a public hearing held on February 2, 1993.

In addition, on October 10, 1990, proposed and temporary regulations under §1.149(b)(3)-1T were published in the Federal Register. These regulations provide that certain investments in obligations issued by the Resolution Funding Corporation under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 are excepted from the prohibition on federal guarantees of tax-exempt bonds under section 149(b).

After consideration of the comments, the proposed regulations have been modified and are adopted in final form. Certain comments on the proposed regulations, and responses to those comments, are discussed below.

II. Comments on Proposed Regulations and Certain Changes in Final Regulations

A. In general. The proposed regulations substantially revise the arbitrage regulations on tax-exempt bonds to simplify those rules and to reduce administrative burdens. The proposed regulations provide greater coordination of the rules on yield restriction and rebate, more unified definitions, general anti-abuse rules in lieu of numerous special rules, clarification of ambiguous areas, and new guidance on many previously reserved topics. Although numerous modifications have been made to clarify the regulations in various technical respects in response to comments received, the general principles behind the proposed regulations have been retained in the final regulations.

B. Section 1.148-1 Definitions and Elections. 1. Computation Date and Computation Period. Rebate is computed over permitted computation periods occurring between computation dates. The proposed regulations generally provide issuers of variable yield issues with flexibility to choose computation dates and computation periods for computing yield on an issue for rebate purposes. Commentators requested clarification of the scope of this flexibility. The final regulations retain significant flexibility to choose these dates and periods until the date that the first required rebate payment must be made (i.e., 5 years after the issue date), but provide a more limited choice of permitted computation periods thereafter.

2. De Minimis Original Issue Discount or Premium. The proposed regulations generally permit issuers to value certain bonds and investments having standard features and not more than de minimis amounts of original issue discount or premium ("plain par bonds" and "plain par investments"), based on a simplified measure of outstanding principal amount. The definition of de minimis amount applies for a variety of purposes. De minimis original issue discount or premium is generally defined in the proposed regulations as an amount that does not exceed 0.25 percent multiplied by the product of the stated redemption price at maturity and the number of complete years to final maturity from the issue date.

To decrease complexity and to minimize certain identified distortions, the final regulations limit the measure of this de minimis amount for valuation purposes to a flat percentage of the stated redemption price at maturity. In a related change, the final regulations clarify that plain par bonds eligible for the simplified valuation rules include certain tender option bonds (i.e., "qualified tender bonds" under Notice 88-130, 1988-2 C.B. 543).

3. Program Investments. The proposed regulations change certain aspects of the existing definition of "program investments" under §1.103-13(h). Commentators recommended that the existing definition generally be retained, particularly its treatment of multifamily housing loans as eligible program investments. The final regulations revise this definition to be more consistent with the existing definition.

4. Investment-Type Property. Whether an item financed with bond proceeds is investment property, including investment-type property, generally determines whether that item is subject to arbitrage restrictions under section 148. The

proposed regulations provide a definition of investment-type property that includes certain prepayments based on the investment motivation for the prepayment. Commentators expressed concern that this provision was too broad and potentially covered common prepayments made for bona fide business reasons. The final regulations provide two exceptions to the general rule on prepayments. One exception focuses on whether the issuer has any commercially reasonable alternative to the prepayment. The other exception focuses on whether similar prepayments are customary among persons not eligible for tax-exempt financing.

5. Replacement Proceeds. The arbitrage restrictions apply to both proceeds received from the sale of bonds and amounts "replaced" by the proceeds. The proposed regulations generally provide that replacement proceeds include, but are not limited to, sinking funds, amounts that are pledged as security for an issue, working capital replacement funds, and amounts that are replaced because of their nexus to a governmental purpose of the issue. Commentators requested that the regulations provide a general definition of replacement proceeds. The final regulations provide a general definition of replacement proceeds based on whether the amounts have a sufficient nexus to the governmental purpose of the issue. The final regulations also clarify that replacement proceeds may arise at any time, regardless of whether the creation of the replacement proceeds is reasonably expected by the issuer on the issue date.

Commentators also requested that the provision dealing with working capital replacement funds be revised or deleted. The final regulations do not include the working capital replacement fund rule. To reduce the arbitrage incentive to issue bonds with longer terms than necessary and to recognize the additional borrowing implicit in these issues, however, the final regulations generally provide that replacement proceeds arise if the term of an issue is reasonably expected to be longer than necessary to accomplish the governmental purpose of the issue and funds are expected to become available during the term of the issue. The final regulations provide two safe harbors against the application of this rule that apply if: (1) An otherwise-restricted working capital financing issue is not outstanding more than 2 years; or (2) a capital project financing issue has a weighted average maturity that does not exceed 120 percent of the economic life of the financed projects. These provisions are only safe harbors relating to the existence of replacement proceeds and are not intended to place a maturity limitation on tax-exempt bonds.

C. Section 1.148-2 General Arbitrage Yield Restriction Rules. 1. Reasonable Expectations. Under section 148(a), bonds are generally taxable arbitrage bonds if, as of the issue date, the issuer reasonably expects to invest the proceeds in higher yielding investments. The proposed regulations permit an issuer to certify its expectations. The proposed regulations also provide certain requirements as a prerequisite to the use of the certification that were intended to encourage more complete disclosure of facts and material tax issues. Commentators expressed concern that some of these requirements were unduly burdensome and created practical difficulties for issuers.

The final regulations significantly modify the certification requirements to address issuer concerns. The required complete disclosure of facts and material tax issues has been eliminated. The regulations clarify that the certification does not establish any presumptions about the reasonableness of an issuer's expectations. In general, this and other certifications referred to in the final regulations have no special evidentiary status.

2. Temporary Periods. Under section 148(c), proceeds may be invested at a materially higher yield during a reasonable temporary period until needed for the governmental purpose of the issue without causing the bonds of the issue to be arbitrage bonds.

Under the proposed regulations, an issuer must satisfy an expenditure test, a time test, and a due diligence test in order to qualify for the general 3-year temporary period for capital projects, and these tests apply separately to each capital project financed by an issue. Commentators expressed concern about the administrative burden associated with tracking individual capital projects and requested that these tests be applied on an aggregate basis to all capital projects financed by an issue. The final regulations generally adopt this comment, except in the case of certain pooled issues.

Commentators expressed concern that the 13-month temporary period for proceeds used for working capital expenditures was inadequate for certain issuers who, under local law, have a longer period between their annual budget cycle and the tax collections for that period. The final regulations provide a temporary period of up to 2 years after the issue date for this type of issue.

3. Minor Portion. In response to comments, the final regulations permit issuers to waive at any time the ability to invest amounts constituting a minor portion of an issue at an unrestricted yield.

D. Section 1.148-3 General Arbitrage Rebate Rules. 1. Computation Date Credit. The proposed regulations provide that, for purposes of computing rebate, an issuer is entitled to a computation date credit of $5,000 on the last day of each fifth bond year and on the final maturity date. In order to target the credit more closely to the periods associated with the computations, the final regulations change the credit to $1,000 for each bond year during which there are gross proceeds of the issue and for the final maturity date.

2. Bona Fide Debt Service Funds. In response to comments, the final regulations add a safe harbor relating to the statutory exception to the rebate requirement for certain bona fide debt service funds, based on a specified maximum average annual debt service on an issue.

E. Section 1.148-4 Yield on an Issue of Bonds. 1. Yield Recomputation for a Fixed Yield Issue. The proposed regulations generally provide that yield on a fixed yield issue is determined as of the issue date and, except in narrow circumstances involving hedging transactions, is not recomputed to take into account subsequent unexpected events. The final regulations generally retain this approach for rebate purposes.

Many commentators requested guidance on the Federal income tax consequences of an issuer's sale of a right associated with a bond, such as a call right, in a separate transaction from the original sale of the bond (e.g., so-called "detachable calls"). These comments included requests for guidance on whether the sale affects the yield on the bond for arbitrage purposes under section 148 and whether the sale results in a deemed retirement of the related bond and the deemed issuance of a new bond (a reissuance) under the tax-exempt bond rules or section 1001. The final regulations clarify that amounts received by the issuer from the sale of a detachable call are taken into account as additional issue price on the issue for rebate purposes. No implication is intended on whether the sale of a detachable call results in a reissuance of the issue under section 1001. It is anticipated that this issue will be addressed in regulations under section 1001.

2. Bonds Subject to Mandatory or Contingent Early Redemption. Under the proposed regulations, the yield on certain fixed yield bonds subject to mandatory early redemption is computed by treating those bonds as redeemed on the reasonably expected early redemption date for an amount equal to their value. The proposed regulations further provide that the outstanding stated principal amount (plus accrued interest) of the bond may be treated as its value if the original issue discount on the bond does not exceed a de minimis amount. The final regulations generally retain this rule, but further limit the permitted de minimis amount to an amount based on the number of years to the weighted average maturity date, rather than the final maturity date, of substantially identical bonds.

3. Bonds Subject to Optional Early Redemption. The proposed regulations contain a special rule for computing the yield on an issue containing bonds that are subject to optional early redemption and that have certain early redemption rights, significant premium, or so-called "stepped-coupons." The yield on an issue subject to this special rule is computed by treating the bonds as redeemed on the optional redemption date that would produce the lowest yield. The final regulations generally retain this rule, but exclude certain bonds if their assumed redemption has only a minimal effect on the yield on the issue of which the bond is a part.

4. Qualified Guarantees. The proposed regulations provide simplified rules under which issuers may take into account certain fees for credit enhancement, such as bond insurance and letters of credit ("qualified guarantees") in computing yield on an issue. The final regulations clarify that certain liquidity arrangements may be qualified guarantees and provide a safe harbor for the allocation of qualified guarantee fees in variable yield issues.

5. Qualified Hedging Transactions. The proposed regulations permit issuers to take certain qualified hedging transactions into account for purposes of computing yield on an issue. Under the proposed regulations, a hedge is generally a qualified hedging transaction if the terms of the hedge closely correspond with the terms of the issue and if the hedge is adequately identified. Commentators requested that the types of qualified hedging transactions be expanded.

The final regulations generally expand the definition of a qualified hedging transaction in various respects. The final regulations permit hedges for less than the entire term of the issue and hedges relating to less than all of the bonds of an issue. The final regulations also treat certain additional hedging products (e.g., interest rate caps) as qualified hedging transactions. The final regulations generally treat issues that involve qualified hedging transactions as variable yield issues. Certain variable rate issues that use interest rate swaps involving no nonperiodic hedge payments, however, are treated as fixed yield issues. The final regulations amend the identification, accounting, and other technical rules on qualified hedging transactions.

F. Section 1.148-5 Yield and Valuation of Investments. 1. Yield on a Separate Class of Investments. The proposed regulations provide that the yields on individual investments within the same class of investments are blended together for purposes of applying the arbitrage yield restriction rules. Under the proposed regulations, the determination of whether investments are part of the same class is based on whether the investments are subject to the same definition of "materially higher" under the arbitrage yield restriction rules.

Commentators requested that issuers be given greater flexibility to blend the yields on individual investments for arbitrage yield restriction purposes. The final regulations provide expanded flexibility to blend yields on various categories of investments. The general anti-abuse rules in §1.148-10 clarify, however, that certain financing structures that improperly exploit these rules cause the bonds to be arbitrage bonds.

2. Yield Reduction Payments to the United States. The proposed regulations provide significant integration of the arbitrage yield restriction and rebate provisions by permitting certain payments to be made to the United States to reduce the yield on investments for yield restriction purposes. The proposed regulations permit these payments in specified circumstances in which arbitrage yield restriction creates administrative difficulties.

Commentators requested that the scope of the rule on yield reduction payments be expanded in various respects. The final regulations expand the ability of issuers to make yield reduction payments in additional circumstances involving certain variable yield issues and certain reserve funds. For purpose investments, the final regulations also delay the due date for these payments.

3. Administrative Costs of Investments. The proposed regulations permit reasonable direct administrative costs on all investments to be taken into account in computing yield on the investments and rebate on the issue. The proposed regulations further provide, however, that indirect costs such as general overhead may not be taken into account. Commentators requested clarification of the scope of permitted administrative costs. The final regulations provide additional examples of the types of qualifying and nonqualifying administrative costs. The final regulations also provide special rules for administrative costs on regulated investment companies, certain external commingled funds, and program investments.

G. Section 1.148-6 General Allocation and Accounting Rules. 1. Universal Cap on Value of Investments Allocated to an Issue. The proposed regulations generally retain the universal cap provided under the existing regulations that limits the amount of gross proceeds allocable to a bond issue. Commentators expressed concern that in some cases the application of the universal cap creates unnecessary administrative burdens. The final regulations reduce the frequency with which the universal cap must be applied and also permit issuers to disregard the universal cap altogether in specified circumstances.

2. Expenditures of Proceeds for Working Capital Purposes. For working capital expenditures, the proposed regulations generally retain the "proceeds-spent-last" accounting method from the existing regulations. Bond proceeds generally are not treated as spent under this rule until other available amounts have been spent. The proposed regulations permit an amount equal to 10 percent of the previous fiscal

year's working capital expenditures to be treated as an unavailable, reasonable reserve. Commentators requested certain clarifications, including whether an issuer may, in effect, finance the permitted working capital reserve (e.g., by issuing bonds in an amount equal to the working capital reserve and spending those proceeds while accumulating a like amount to serve as the reserve).

Based on a review of these comments and re-consideration of this area in light of continuing policy concerns regarding the arbitrage incentives to issue larger working capital financings than necessary, the final regulations impose certain further limitations on working capital financings. The final regulations retain the approach of the existing and proposed regulations that measures the permitted working capital reserve by reference to the previous year's actual working capital expenditures. To further limit overissuance, the permitted working capital reserve has been reduced to 5 percent of the issuer's working capital expenditures for the prior year. In addition, the final regulations clarify that, except in the case of issues by certain small issuers and issues that are exempt from rebate under the section 148(f)(4)(B)(iii) rebate safe harbor, an issue indirectly used to finance a working capital reserve results in the creation of replacement proceeds that remain subject to the arbitrage rules. In a related change, the definition of "controlled group," which is relevant in determining the available amounts, has been narrowed. In addition, in response to comments, the final regulations also exclude from the amounts considered available for working capital purposes certain "quasi-endowment funds" held by hospitals, universities, or similar institutions.

H. Section 1.148-7 Spending Exceptions to the Rebate Requirement. The proposed regulations provide a new 18-month spending exception to the rebate requirement that is broadly applicable and requires prompt expenditure of bond proceeds under a prescribed, approximately level spending schedule. This new spending exception was introduced because of the difficulties many issuers had using the existing spending exceptions. Commentators were largely supportive of the new 18-month exception, but requested that the spending percentage for the first 6-month period be reduced. The final regulations reduce the spending percentage for this period to 15 percent.

I. Section 1.148-8 Small Issuer Exception to the Rebate Requirement. For purposes of the small issuer exception to rebate, bonds issued by a subordinate entity are treated as also issued by each entity to which it is subordinate. The proposed regulations provide a definition of "subordinate entity" based on issuing authority and control. Commentators requested that the general section 150 definition of "controlled entity" be extended to define a "subordinate entity." The final regulations adopt this comment.

J. Section 1.148-9 Arbitrage Rules for Refunding Issues. 1. Transferred Proceeds Allocation Rule. The proposed regulations provide a "principal-to-principal" transferred proceeds allocation rule similar to that of the existing regulations, under which unspent proceeds of a prior issue become transferred proceeds of a refunding issue at the time that proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue. The proposed regulations generally do not include an "operating rule" (as under former §1.103-14(e)(1)) to divide a prior issue into refunded and unrefunded portions for transferred proceeds purposes.

Commentators requested that an operating rule be included to provide simplification and greater certainty in the planning of refunding issues. The final regulations provide such a rule.

2. Multipurpose Issue Allocations. The proposed regulations contain a flexible multipurpose issue allocation rule that permits issues used for separate governmental purposes to be treated as separate issues for prescribed purposes. In the case of a multipurpose issue a portion of which is a refunding issue, the proposed regulations permit issuers to use only certain specified allocation methods to allocate bonds of the multipurpose issue to the refunding of the prior issue. Commentators expressed concern that, in certain circumstances, an issuer may have no practical way to use any of the required allocation methods under this rule. The final regulations add another allocation rule permitting allocations in proportion to the average economic lives of the facilities financed by the overall multipurpose issue. In addition, the final regulations permit an issuer to use another reasonable allocation method in limited circumstances based on state law, existing legal restrictions, or similar circumstances.

The final regulations expand the applicability of the multipurpose issue rule for an issue that refunds two or more prior issues and provide additional rules for allocating the proceeds of these issues. The final regulations also permit the application of the multipurpose issue rule to divide certain pooled issues for yield calculation purposes.

K. Section 1.148-10 Anti-Abuse Rules and Authority of Commissioner. The proposed regulations provide a broad, general anti-abuse rule that treats bonds as taxable arbitrage bonds if the issuer uses an abusive device to obtain a material financial advantage based on arbitrage. This general anti-abuse rule proposes to replace the general artifice or device rules contained in §1.103-13(j) and §1.148-9(g) and numerous specific anti-abuse rules. Commentators expressed concern that the general anti-abuse rule in the proposed regulations is not sufficiently specific for issuers to determine whether a particular transaction violates the rule.

The final regulations retain a broad, general anti-abuse rule, but provide additional specific guidance intended to clarify further the scope of covered abusive transactions. In large part, the revised abusive arbitrage device provision is based on the existing artifice or device prohibition in §1.103-13(j). The revised rule continues to focus on transactions that exploit the difference between tax-exempt and taxable interest rates and that overburden the tax-exempt bond market. Although many clarifications have been made to these rules, no implication is intended regarding the scope of the existing artifice or device rule or that the examples of abusive arbitrage devices do not involve artifices or devices.

L. Section 149(d)-1 Limitations on Advance Refundings. 1. General Rule. Section 149(d) provides limits on advance refundings, including limitations on the number of permitted tax-exempt advance refundings. The final regulations provide additional guidance relating to the requirement that the refunded bonds be retired on their first call date and the related savings test.

2. Sales of Tax-exempt Conduit Loans. The proposed regulations include a provision under the anti-abuse rules that treats tax-exempt purpose investments financed by a conduit financing issue as taxable investments if they are subsequently transferred to another party. Without some limitations on these transactions, issuers could

effectively double the amount of tax-exempt bonds on the market for a single project. Commentators expressed concern that this provision is overly broad and recommended that these transactions instead be treated under a refunding analysis. The final regulations adopt this more direct approach by treating the actual issuer of the conduit financing and the conduit borrower as related parties for purposes of section 149(d). Thus, a later sale of the conduit loan is treated as a new issue the yield on which is determined based on the amounts derived from that sale. If the proceeds of that deemed new issue are used to pay debt service on the conduit financing issue, the conduit loan is treated as a refunding issue. Further, the abusive arbitrage device rules illustrate that this type of transaction may involve an exploitation of the difference between taxable and tax-exempt rates.

M. Section 1.150-1 Definitions. 1. Issue. The proposed regulations provide a new definition of issue for arbitrage and related purposes. In response to comments, and to promote simplification, the final regulations extend this definition to apply for all tax-exempt bond purposes. The final regulations provide additional guidance on whether obligations are issued at substantially the same time, sold pursuant to the same plan of financing, and are reasonably expected to be paid from the same source of funds. The final regulations generally provide that taxable and tax-exempt bonds are not part of a single issue and clarify the special rules for commercial paper and draw-down loans. The final regulations also provide that issuers may treat tax-exempt governmental bonds and private activity bonds as separate issues under specified circumstances.

2. Controlled Group. The proposed regulations provide a definition of controlled group that focuses on control of the governing board, budgetary control, and control over the ability to issue debt obligations. The final regulations narrow the definition of controlled group to focus on board control and financial control. The final regulations also provide that certain general purpose governmental units are not controlled by any other entity.

N. Section 1.150-2 Proceeds of Bonds used for Reimbursement. The proposed regulations provide simplified and expanded rules to determine when an allocation of bond proceeds to reimburse expenditures previously made by an issuer is treated as an expenditure of those bond proceeds. The proposed regulations require an issuer to reimburse past expenditures with bond proceeds within a prescribed period that is not later than 3 years after the expenditure is paid. Commentators expressed concern that the 3-year overall limit on the reimbursement period may be too short for certain types of projects. The final regulations expand the maximum reimbursement period to 5 years for certain long-term construction projects. Commentators also requested that a rule under prior regulations excluding certain preliminary expenditures from the reimbursement rules be reinserted. The final regulations include such a preliminary expenditures exception.

Commentators also noted that the proposed regulations and §1.103-8(a)(5) were duplicative and requested clarification of the continued application of §1.103-8(a)(5). The final regulations eliminate the official action requirement of §1.103-8(a)(5).

O. Federal Guarantees. The final regulations also finalize the regulations under §1.149(b)(3)-1T relating to the exception from the section 149(d) prohibition against federal guarantees for certain investments in obligations issued by the Resolution Funding Corporation under the Financial Institutions Reform, Recovery, and

Enforcement Act of 1989. In addition, the final regulations provide an expanded exception under which bonds are not federally guaranteed as a result of an investment in a refunding escrow.

P. Effective Dates. The final regulations generally apply to bonds issued after June 30, 1993. To simplify the area and promote compliance, the final regulations generally permit elective, retroactive application of the final regulations in whole, but not in part, to outstanding issues issued prior to July 1, 1993, that are subject to the rebate requirement. The 18-month spending exception, however, may not be applied retroactively. The final regulations also provide certain other transition and related rules. The final regulations also extend the due date for rebate payments due after June 30, 1993, to a date not earlier than September 1, 1993.

Finally, in order to not interfere with ongoing transactions, at the issuer's option, certain existing provisions may be applied to bonds issued before August 15, 1993.

Special Analyses

It has been determined that these final regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Scott R. Lilienthal, William P. Cejudo, Michael G. Bailey, Lon B. Smith, and John J. Cross III of the Office of Assistant Chief Counsel (Financial Institutions and Products), Internal Revenue Service, and Mitchell H. Rapaport, Office of Tax Legislative Counsel, Department of the Treasury. However, other personnel from the Service and Treasury Department participated in their development.

List of Subjects

26 CFR Parts 1 and 6a

Income taxes, Reporting and recordkeeping requirements.

26 CFR 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 6a and 602 are amended as follows:

Paragraph 1. The authority citation for part 1 is amended by removing the entries for "Sections 1.148-0 through 1.148-9," "Section 1.148-10," "Section 1.148-11", "Section 1.148-12T" "Section 1.148-13T" and "Section 1.149(b)(3)-1T" and adding the following citations to read as follows:

Authority:

26 U.S.C. 7805 Sections 1.148-0 through 1.148-11 also issued under 26 U.S.C. 148 (f), (g), and (i).

Section 1.149(b)-1 also issued under 26 U.S.C. 149(b)(3)(B) (v).

Section 1.149(g)-1 also issued under 26 U.S.C. 149(g)(5).

Par. 2. Section 1.103-8(a)(5) is revised to read as follows:

§1.103-8 Interest on bonds to finance certain exempt facilities.

(a)

(5) Limitation. (i) A facility qualifies under this section only to the extent that there is a valid reimbursement allocation under §1.150-2 with respect to expenditures that are incurred before the issue date of the bonds to provide the facility and that are to be paid with the proceeds of the issue. In addition, if the original use of the facility begins before the issue date of the bonds, the facility does not qualify under this section if any person or related person who is a substantial user of the facility during the 5-year period beginning on the issue date was a substantial user of the facility during the 5-year period ending on the issue date.

(ii) Except to the extent provided in §1.150-2(j), this paragraph (a)(5) applies to bonds issued after June 30, 1993.

§§1.103-13, 1.103-13T, 1.103-14, 1.103-15 and 1.103-18 (Removed)

Par. 3. Sections 1.103-13, 1.103-13T, 1.103-14, 1.103-15, and 1.103-18 are removed.

Par. 4. Section 1.147(b)-1 is added to read as follows:

§1.147(b)-1 Bond maturity limitation-treatment of working capital.

Section 147(b) does not apply to proceeds of a private activity bond issue used to finance working capital expenditures.

Par. 5. Sections 1.148-0 through 1.148-11 are revised to read as set forth below:

§1.148-0 Scope and table of contents.

(a) Overview. Under section 103(a), interest on certain obligations issued by States and local governments is excludable from the gross income of the owners. Section

148 was enacted to minimize the arbitrage benefits from investing gross proceeds of tax-exempt bonds in higher yielding investments and to remove the arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued. To accomplish these purposes, section 148 restricts the direct and indirect investment of bond proceeds in higher yielding investments and requires that certain earnings on higher yielding investments be rebated to the United States. Violation of these provisions causes the bonds in the issue to become arbitrage bonds, the interest on which is not excludable from the gross income of the owners under section 103(a). The regulations in §§1.148-1 through 1.148-11 apply in a manner consistent with these purposes.

(b) Scope. Sections 1.148-1 through 1.148-11 apply generally for purposes of the arbitrage restrictions on State and local bonds under section 148.

(c) Table of contents. This paragraph (c) lists the table of contents for §§1.148-1 through 1.148-11.

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§1.148-1 Definitions and elections.

(a) In general. The definitions in this section and the definitions under section 150 apply for purposes of section 148 and §§1.148-1 through 1.148-11.

(b) Certain definitions. The following definitions apply:

Accounting method means both the overall method used to account for gross proceeds of an issue (e.g., the cash method or a modified accrual method) and the method used to account for or allocate any particular item within that overall accounting method (e.g., accounting for investments, expenditures, allocations to and from different sources, and particular items of the foregoing).

Annuity contract means annuity contract as defined in section 72.

Available amount means available amount as defined in §1.148-6(d)(3)(iii).

Bona fide debt service fund means a fund, which may include proceeds of an issue, that-

(1) Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and

(2) Is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of:

(i) the earnings on the fund for the immediately preceding bond year; or

(ii) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

Bond year means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. The first and last bond years may be short periods. If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, bond years end on each anniversary of the issue date and on the final maturity date.

Capital project or capital projects means all capital expenditures, plus related working capital expenditures to which the de minimis rule under §1.148-6(d)(3)(ii)(A) applies, that carry out the governmental purposes of an issue. For example, a capital project may include capital expenditures for one or more buildings, plus related start-up operating costs.

Commingled fund means any fund or account containing both gross proceeds of an issue and amounts in excess of $25,000 that are not gross proceeds of that issue if the amounts in the fund or account are invested and accounted for collectively, without regard to the source of funds deposited in the fund or account. An open-end regulated investment company under section 851, however, is not a commingled fund.

Computation date means each date on which the rebate amount for an issue is computed under §1.148-3(e).

Computation period means the period between computation dates. The first computation period begins on the issue date and ends on the first computation date. Each succeeding computation period begins on the date immediately following the computation date and ends on the next computation date.

Consistently applied means applied uniformly within a fiscal period and between fiscal periods to account for gross proceeds of an issue and any amounts that are in a commingled fund.

De minimis amount means-

(1) In reference to original issue discount (as defined in section 1273(a)(1)) or premium on an obligation-

(i) An amount that does not exceed 2 percent multiplied by the stated redemption price at maturity; plus

(ii) Any original issue premium that is attributable exclusively to reasonable underwriters' compensation; and

(2) In reference to market discount (as defined in section 1278(a)(2)(A)) or premium on an obligation, an amount that does not exceed 2 percent multiplied by the stated redemption price at maturity.

Economic accrual method (also known as the constant interest method or actuarial method) means the method of computing yield that is based on the compounding of interest at the end of each compounding period.

Fair market value means fair market value as defined in §1.148-5(d)(6).

Fixed rate investment means any investment whose yield is fixed and determinable on the issue date.

Fixed yield bond means any bond whose yield is fixed and determinable on the issue date using the assumptions and rules provided in §1.148-4(b).

Fixed yield issue means any issue if each bond that is part of the issue is a fixed yield bond.

Gross proceeds means any proceeds and replacement proceeds of an issue.

Guaranteed investment contract includes any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates (e.g., a forward supply contract).

Higher yielding investments means higher yielding investments as defined in section 148(b)(1).

Investment means any investment property as defined in sections 148(b)(2) and 148(b)(3), and any other tax-exempt bond.

Investment proceeds means any amounts actually or constructively received from investing proceeds of an issue.

Investment-type property includes any property, other than property described in section 148(b)(2) (A), (B), (C), or (E), that is held principally as a passive vehicle for the production of income. Except as otherwise provided, a prepayment for property or services is investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment is not investment-type property if-

(1) The prepayment is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment, or

(2) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing.

Issue price means, except as otherwise provided, issue price as defined in sections 1273 and 1274. Generally, the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. Ten percent is a substantial amount. The public does not include bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. The issue price does not change if part of the issue is later sold at a different price. The issue price of bonds that are not substantially identical is determined separately. The issue price of bonds for which a bona fide public offering is made is determined as of the sale date based on reasonable expectations regarding the initial public offering price. If a bond is issued for property, the applicable Federal tax-exempt rate is used in lieu of the Federal rate in determining the issue price under section 1274. The issue price of bonds may not exceed their fair market value as of the sale date.

Issuer generally means the entity that actually issues the issue, and, unless the context or a provision clearly requires otherwise, each conduit borrower of the issue. For example, rules imposed on issuers to account for gross proceeds of an issue apply to a conduit borrower to account for any gross proceeds received under a purpose investment. Provisions regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations apply only to the actual issuer.

Multipurpose issue means an issue the proceeds of which are used for two or more separate purposes determined in accordance with §1.148-9(h).

Net sale proceeds means sale proceeds, less the portion of those sale proceeds invested in a reasonably required reserve or replacement fund under section 148(d) and as part of a minor portion under section 148(e).

Nonpurpose investment means any investment property, as defined in section 148(b), that is not a purpose investment.

Payment means a payment as defined in §1.148-3(d) for purposes of computing the rebate amount, and a payment as defined in §1.148-5(b) for purposes of computing the yield on an investment.

Plain par bond means a qualified tender bond or a bond-

(1) Issued with not more than a de minimis amount of original issue discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Plain par investment means an investment that is an obligation-

(1) Issued with not more than a de minimis amount of original issue discount or premium, or, if acquired on a date other than the issue date, acquired with not more than a de minimis amount of market discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Pre-issuance accrued interest means amounts representing interest that accrued on an obligation for a period not greater than one year before its issue date but only if those amounts are paid within one year after the issue date.

Proceeds means any sale proceeds, investment proceeds, and transferred proceeds of an issue. Proceeds do not include, however, amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under §1.148-2(d) or section 143(g) or to qualified administrative costs recoverable under §1.148-5(e).

Program investment means a purpose investment that is part of a governmental program in which-

(1) The program involves the origination or acquisition of purpose investments;

(2) At least 95 percent (90 percent for qualified student loans under section 144(b)(1)(A)) of the cost of the purpose investments acquired under the program represents one or more loans to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, persons who provide housing and related facilities, or any combination of the foregoing;

(3) At least 95 percent of the receipts from the purpose investments are used to pay principal, interest, or redemption prices on issues that financed the program, to pay or reimburse administrative costs of those issues or of the program, to pay or reimburse anticipated future losses directly related to the program, to finance additional purpose investments for the same general purposes of the program, or to redeem and retire governmental obligations at the next earliest possible date of redemption;

(4) The program documents prohibit any obligor on a purpose investment financed by the program or any related party to that obligor from purchasing bonds of an issue that finance the program in an amount related to the amount of the purpose investment acquired from that obligor; and

(5) The issuer has not waived the right to treat the investment as a program investment.

Purpose investment means an investment that is acquired to carry out the governmental purpose of an issue.

Qualified administrative costs means qualified administrative costs as defined in §1.148-5(e).

Qualified guarantee means a qualified guarantee as defined in §1.148-4(f).

Qualified hedge means a qualified hedge as defined in §1.148-4(h)(2).

Reasonable expectations or reasonableness. An issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. Factors relevant to a determination of reasonableness include the issuer's history of conduct concerning stated expectations made in connection with the issuance of obligations, the level of inquiry by the issuer into factual matters, and the existence of covenants, enforceable by bondholders, that require implementation of specific expectations. For a conduit financing issue, factors relevant to a determination of reasonableness include the reasonable expectations of the conduit borrower, but only if, under the circumstances, it is reasonable and prudent for the issuer to rely on those expectations.

Rebate amount means 100 percent of the amount owed to the United States under section 148(f)(2), as further described in §1.148-3.

Receipt means a receipt as defined in §1.148-3(d) for purposes of computing the rebate amount, and a receipt as defined in §1.148-5(b) for purposes of computing yield on an investment.

Refunding escrow means one or more funds established as part of a single transaction or a series of related transactions, containing proceeds of a refunding issue and any other amounts to provide for payment of principal or interest on one or more prior issues. For this purpose, funds are generally not so established solely because of-

(1) The deposit of proceeds of an issue and replacement proceeds of the prior issue in an escrow more than 6 months apart, or

(2) The deposit of proceeds of completely separate issues in an escrow.

Restricted working capital expenditures means working capital expenditures that are subject to the proceeds-spent-last rule in §1.148-6(d)(3)(i) and are ineligible for any exception to that rule.

Sale proceeds means any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount or compensation and accrued interest other than pre-issuance accrued interest.

Stated redemption price means the redemption price of an obligation under the terms of that obligation, including any call premium.

Transferred proceeds means transferred proceeds as defined in §1.148-9 (or the applicable corresponding provision of prior law).

Unconditionally payable means payable under terms in which-

(1) Late payment or nonpayment results in a significant penalty to the borrower or reasonable remedies to the lender, and

(2) It is reasonably certain on the issue date that the payment will actually be made.

Value means value determined under §1.148-4(e) for a bond, and value determined under §1.148-5(d) for an investment.

Variable yield bond means any bond that is not a fixed yield bond.

Variable yield issue means any issue that is not a fixed yield issue.

Yield means yield computed under §1.148-4 for an issue, and yield computed under §1.148-5 for an investment.

Yield restricted means required to be invested at a yield that is not materially higher than the yield on the issue under section 148(a) and §1.148-2.

(c) Definition of replacement proceeds-(1) In general. Amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in paragraph (c)(4) of this section, to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.

(2) Sinking fund. Sinking fund includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue.

(3) Pledged fund-(i) In general. A pledged fund is any amount that is directly or indirectly pledged to pay principal or interest on the issue. A pledge need not be cast in any particular form but, in substance, must provide reasonable assurance that the amount will be available to pay principal or interest on the issue, even if the issuer encounters financial difficulties. A pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the issue. A pledge of more than 50 percent of the outstanding stock of a corporation that is a conduit borrower of the issue is not treated as a pledge for this purpose, unless the corporation is formed or availed of to avoid the creation of replacement proceeds.

(ii) Negative pledges. An amount is treated as pledged to pay principal or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged under this paragraph (c)(3)(ii), however, if-

(A) The issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or

(B) The amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date.

(4) Other replacement proceeds-(i) Bonds outstanding longer than necessary-(A) In general. Replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that-

(1) The term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue, and

(2) There will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under §1.148-10. Replacement proceeds are created under this paragraph (c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

(B) Safe harbor against creation of replacement proceeds. As a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of this section-

(1) For the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years;

(2) For the portion of an issue that is to be used to finance capital projects, if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects, determined in the same manner as under section 147(b); or

(3) For the portion of an issue that is a refunding issue, if that portion has a weighted average maturity that does not exceed the remaining weighted average

maturity of the prior issue, and the issue of which the prior issue is a part satisfies paragraph (c)(4)(i)(B) (1) or (2) of this section.

(ii) Bonds financing a working capital reserve-(A) In general. Except as otherwise provided in paragraph (c)(4)(ii)(B) of this section, replacement proceeds arise to the extent a working capital reserve is, directly or indirectly, financed with the proceeds of the issue (regardless of the expenditure of proceeds of the issue). Thus, for example, if an issuer that does not maintain a working capital reserve borrows to fund such a reserve, the issuer will have replacement proceeds.

(B) Exception to creation of replacement proceeds. Replacement proceeds do not arise under paragraph (c)(4)(ii)(A) of this section with respect to an issue-

(1) All of the net proceeds of which are spent within 6 months of the issue date under section 148(f)(4)(B)(iii)(I); or

(2) That is not subject to the rebate requirement under the exception provided by section 148(f)(4)(D).

(d) Elections. Except as otherwise provided, any required elections must be made in writing, and, once made, may not be revoked without the permission of the Commissioner.

§1.148-2 General arbitrage yield restriction rules.

(a) In general. Under section 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. The investment of proceeds in higher yielding investments, however, during a temporary period described in paragraph (e) of this section, as part of a reasonably required reserve or replacement fund described in paragraph (f) of this section, or as part of a minor portion described in paragraph (g) of this section does not cause the bonds of the issue to be arbitrage bonds. Bonds are not arbitrage bonds under this section as a result of an inadvertent, insubstantial error.

(b) Reasonable expectations-(1) In general. Except as provided in paragraph (c) of this section, the determination of whether an issue consists of arbitrage bonds under section 148(a) is based on the issuer's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of the issue.

(2) Certification of expectations-(i) In general. An officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's expectations as of the issue date. The certification must state the facts and estimates that form the basis for the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.

(ii) Exceptions to certification requirement. An issuer is not required to make a certification for an issue under paragraph (b)(2)(i) of this section if-

(A) The issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund (e.g., equipment lease financings in which the issuer purchases equipment in exchange for an installment payment note); or

(B) The issue price of the issue does not exceed $250,000.

(c) Intentional acts. The taking of any deliberate, intentional action by the issuer or person acting on its behalf after the issue date in order to earn arbitrage causes the bonds of the issue to be arbitrage bonds if that action, had it been expected on the issue date, would have caused the bonds to be arbitrage bonds. An intent to violate the requirements of section 148 is not necessary for an action to be intentional.

(d) Materially higher yielding investments-(1) In general. The yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by an amount in excess of the applicable definition of materially higher set forth in paragraph (d)(2) of this section. If yield restricted investments in the same class are subject to different definitions of materially higher, the applicable definition of materially higher that produces the lowest permitted yield applies to all the investments in the class. The yield on the issue is determined under §1.148-4. The yield on investments is determined under §1.148-5.

(2) Definitions of materially higher yield-(i) General rule for purpose and nonpurpose investments. For investments that are not otherwise described in this paragraph (d)(2), materially higher means one-eighth of 1 percentage point.

(ii) Refunding escrows and replacement proceeds. For investments in a refunding escrow or for investments allocable to replacement proceeds, materially higher means one-thousandth of 1 percentage point.

(iii) Program investments. For program investments that are not described in paragraph (d)(2)(iv) of this section, materially higher means 1 and one-half percentage points.

(iv) Student loans. For qualified student loans that are program investments, materially higher means 2 percentage points.

(v) Tax-exempt investments. For investments that are tax-exempt bonds and are not investment property under section 148(b)(3), no yield limitation applies.

(3) Mortgage loans. Qualified mortgage loans that satisfy the requirements of section 143(g) are treated as meeting the requirements of this paragraph (d).

(e) Temporary periods-(1) In general. During the temporary periods set forth in this paragraph (e), the proceeds and replacement proceeds of an issue may be invested in higher yielding investments without causing bonds in the issue to be arbitrage bonds. This paragraph (e) does not apply to refunding issues (see §1.148-9).

(2) General 3-year temporary period for capital projects and qualified mortgage loans-(i) In general. The net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of 3 years beginning on the issue date (the 3-year temporary

period). The 3-year temporary period also applies to the proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds by substituting qualified mortgage loans in each place that capital projects appears in this paragraph (e)(2). The 3-year temporary period applies only if the issuer reasonably expects to satisfy the expenditure test, the time test, and the due diligence test. These rules apply separately to each conduit loan financed by an issue (other than qualified mortgage loans), with the expenditure and time tests measured from the issue date of the issue.

(A) Expenditure test. The expenditure test is met if at least 85 percent of the net sale proceeds of the issue are allocated to expenditures on the capital projects by the end of the 3-year temporary period.

(B) Time test. The time test is met if the issuer incurs within 6 months of the issue date a substantial binding obligation to a third party to expend at least 5 percent of the net sale proceeds of the issue on the capital projects. An obligation is not binding if it is subject to contingencies within the issuer's or a related party's control.

(C) Due diligence test. The due diligence test is met if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures proceed with due diligence.

(ii) 5-year temporary period. In the case of proceeds expected to be allocated to a capital project involving a substantial amount of construction expenditures (as defined in §1.148-7), a 5-year temporary period applies in lieu of the 3-year temporary period if the issuer satisfies the requirements of paragraph (e)(2)(i) of this section applied by substituting "5 years" in each place that "3 years" appears, and both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project.

(3) Temporary period for restricted working capital expenditures-(i) General rule. The proceeds of an issue that are reasonably expected to be allocated to restricted working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. Paragraph (e)(2) of this section contains additional temporary period rules for certain working capital expenditures that are treated as part of a capital project.

(ii) Longer temporary period for certain tax anticipation issues. If an issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of 2 years after the issue date or 60 days after the last date for payment of those taxes without interest or penalty, the temporary period under paragraph (e)(3)(i) of this section is extended until the maturity date of the issue.

(4) Temporary period for pooled financings-(i) In general. Proceeds of a pooled financing issue reasonably expected to be used to finance purpose investments qualify for a temporary period of 6 months while held by the issuer before being loaned to a conduit borrower. Any otherwise available temporary period for proceeds held by a conduit borrower, however, is reduced by the period of time during which those proceeds were held by the issuer before being loaned. For example, if the proceeds of a pooled financing issue loaned to a conduit borrower would qualify for a 3-year temporary period, and the proceeds are held by the issuer for 5 months

before being loaned to the conduit borrower, the proceeds qualify for only an additional 31-month temporary period after being loaned to the conduit borrower. This paragraph (e)(4) does not apply to any qualified mortgage bond or qualified veterans' mortgage bond under section 143.

(ii) Loan repayments-(A) Amount held by the issuer. The temporary period under this paragraph (e)(4) for proceeds from the sale or repayment of any loan that are reasonably expected to be used to make or finance new loans iSection 3 months.

(B) Amounts re-loaned to conduit borrowers. Any temporary period for proceeds held by a conduit borrower under a new loan from amounts described in paragraph (e)(4)(ii)(A) of this section is determined by treating the date the new loan is made as the issue date and by reducing the temporary period by the period the amounts were held by the issuer following the last repayment.

(iii) Construction issues. If all or a portion of a pooled financing issue qualifies as a construction issue under §1.148-7(b)(6), paragraph (e)(4)(i) of this section is applied by substituting "2 years" for "6 months."

(5) Temporary period for replacement proceeds-(i) In general. Except as otherwise provided, replacement proceeds qualify for a temporary period of 30 days beginning on the date that the amounts are first treated as replacement proceeds.

(ii) Temporary period for bona fide debt service funds. Amounts in a bona fide debt service fund for an issue qualify for a temporary period of 13 months. If only a portion of a fund qualifies as a bona fide debt service fund, only that portion qualifies for this temporary period.

(6) Temporary period for investment proceeds. Except as otherwise provided in this paragraph (e), investment proceeds qualify for a temporary period of 1 year beginning on the date of receipt.

(7) Other amounts. Gross proceeds not otherwise eligible for a temporary period described in this paragraph (e) qualify for a temporary period of 30 days beginning on the date of receipt.

(f) Reserve or replacement funds-(1) General 10 percent limitation on funding with sale proceeds. An issue consists of arbitrage bonds if sale proceeds of the issue in excess of 10 percent of the stated principal amount of the issue are used to finance any reserve or replacement fund, without regard to whether those sale proceeds are invested in higher yielding investments. If an issue has more than a de minimis amount of original issue discount or premium, the issue price (net of pre-issuance accrued interest) is used to measure the 10-percent limitation in lieu of stated principal amount. This rule does not limit the use of amounts other than sale proceeds of an issue to fund a reserve or replacement fund.

(2) Exception from yield restriction for reasonably required reserve or replacement funds-(i) In general. The investment of amounts that are part of a reasonably required reserve or replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds. A reasonably required reserve or replacement fund may consist of all or a portion of one or more funds, however labelled, derived

from one or more sources. Amounts in a reserve or replacement fund in excess of the amount that is reasonably required are not part of a reasonably required reserve or replacement fund.

(ii) Size limitation. The amount of gross proceeds of an issue that qualifies as a reasonably required reserve or replacement fund may not exceed an amount equal to the least of 10 percent of the stated principal amount of the issue, the maximum annual principal and interest requirements on the issue, or 125 percent of the average annual principal and interest requirements on the issue. If an issue has more than a de minimis amount of original issue discount or premium, the issue price of the issue (net of pre-issuance accrued interest) is used to measure the 10 percent limitation in lieu of its stated principal amount. For a reserve or replacement fund that secures more than one issue (e.g. a parity reserve fund), the size limitation may be measured on an aggregate basis.

(iii) Valuation of investments. Investments in a reasonably required reserve or replacement fund may be valued in any reasonable, consistently applied manner that is permitted under §1.148-5.

(iv) 150 percent debt service limitation on investment in nonpurpose investments for certain private activity bonds. Section 148(d)(3) contains additional limits on the amount of gross proceeds of an issue of private activity bonds, other than qualified 501(c)(3) bonds, that may be invested in higher yielding nonpurpose investments without causing the bonds to be arbitrage bonds. For purposes of these rules, initial temporary period means the temporary periods under paragraphs (e)(2), (e)(3), and (e)(4) of this section and under §1.148-9(d)(2)(i), (ii), and (iii).

(3) Certain parity reserve funds. The limitation contained in paragraph (f)(1) of this section does not apply to an issue if the master legal document authorizing the issuance of the bonds (e.g., a master indenture) was adopted before August 16, 1986, and that document-

(i) Requires a reserve or replacement fund in excess of 10 percent of the sale proceeds, but not more than maximum annual principal and interest requirements;

(ii) Is not amended after August 31, 1986 (other than to permit the issuance of additional bonds as contemplated in the master legal document); and

(iii) Provides that bonds having a parity of security may not be issued by or on behalf of the issuer for the purposes provided under the document without satisfying the reserve fund requirements of the indenture.

(g) Minor portion. Under section 148(e), a bond of an issue is not an arbitrage bond solely because of the investment in higher yielding investments of gross proceeds of the issue in an amount not exceeding the lesser of-

(1) 5 percent of the sale proceeds of the issue; or

(2) $100,000.

(h) Certain waivers permitted. On or before the issue date, an issuer may elect to waive the right to invest in higher yielding investments during any temporary period under paragraph (e) of this section or as part of a reasonably required reserve or replacement fund under paragraph (f) of this section. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion under paragraph (g) of this section.

§1.148-3 General arbitrage rebate rules.

(a) In general. Section 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United States to prevent the bonds in the issue from being arbitrage bonds. The arbitrage that must be rebated is based on the difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

(b) Definition of rebate amount. As of any date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments.

(c) Computation of future value of a payment or receipt. The future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when it is paid or received (or treated as paid or received), plus interest assumed to be earned and compounded over the period at a rate equal to the yield on the issue, using the same compounding interval and financial conventions used to compute that yield.

(d) Payments and receipts- (1) Definition of payments. For purposes of this section, payments are-

(i) Amounts actually or constructively paid to acquire a nonpurpose investment (or treated as paid to a commingled fund);

(ii) For a nonpurpose investment that is first allocated to an issue on a date after it is actually acquired (e.g., an investment that becomes allocable to transferred proceeds or to replacement proceeds) or that becomes subject to the rebate requirement on a date after it is actually acquired (e.g., an investment allocated to a reasonably required reserve or replacement fund for a construction issue at the end of the 2-year spending period), the value of that investment on that date;

(iii) For a nonpurpose investment that was allocated to an issue at the end of the preceding computation period, the value of that investment at the beginning of the computation period;

(iv) On the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to the rebate requirement, and on the final maturity date, a computation credit of $1,000; and

(v) Yield reduction payments on nonpurpose investments made pursuant to §1.148-5(c).

(2) Definition of receipts. For purposes of this section, receipts are-

(i) Amounts actually or constructively received from a nonpurpose investment (including amounts treated as received from a commingled fund), such as earnings and return of principal;

(ii) For a nonpurpose investment that ceases to be allocated to an issue before its disposition or redemption date (e.g., an investment that becomes allocable to transferred proceeds of another issue or that ceases to be allocable to the issue pursuant to the universal cap under §1.148-6) or that ceases to be subject to the rebate requirement on a date earlier than its disposition or redemption date (e.g., an investment allocated to a fund initially subject to the rebate requirement but that subsequently qualifies as a bona fide debt service fund), the value of that nonpurpose investment on that date; and

(iii) For a nonpurpose investment that is held at the end of a computation period, the value of that investment at the end of that period.

(3) Special rules for commingled funds. Section 1.148-6(e) provides special rules to limit certain of the required determinations of payments and receipts for investments of a commingled fund.

(e) Computation dates-(1) In general. For a fixed yield issue, an issuer may treat any date as a computation date. For a variable yield issue, an issuer:

(i) May treat the last day of any bond year ending on or before the latest date on which the first rebate amount is required to be paid under paragraph (f) of this section (the first required payment date) as a computation date but may not change that treatment after the first payment date; and

(ii) After the first required payment date, must consistently treat either the end of each bond year or the end of each fifth bond year as computation dates and may not change these computation dates after the first required payment date.

(2) Final computation date. The date that an issue is discharged is the final computation date. For an issue retired within 3 years of the issue date, however, the final computation date need not occur before the end of 8 months after the issue date or during the period in which the issuer reasonably expects that any of the spending exceptions under §1.148-7 will apply to the issue.

(f) Amount of required rebate installment payment-(1) Amount of interim rebate payments. The first rebate installment payment must be made for a computation date that is not later than 5 years after the issue date. Subsequent rebate installment payments must be made for a computation date that is not later than 5 years after the previous computation date for which an installment payment was made. A rebate installment payment must be in an amount that, when added to the future value, as of the computation date, of previous rebate payments made for the issue, equals at least 90 percent of the rebate amount as of that date.

(2) Amount of final rebate payment. For the final computation date, a final rebate payment must be paid in an amount that, when added to the future value of

previous rebate payments made for the issue, equals 100 percent of the rebate amount as of that date.

(3) Future value of rebate payments. The future value of a rebate payment is determined under paragraph (c) of this section. This value is computed by taking into account recoveries of overpayments.

(g) Time and manner of payment. Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. Any rebate payment paid within this 60-day period may be treated as paid on the computation date to which it relates. A rebate payment is paid when it is filed with the Internal Revenue Service at the place or places designated by the Commissioner. A payment must be accompanied by the form provided by the Commissioner for this purpose.

(h) Penalty in lieu of loss of tax exemption-(1) In general. The failure to pay the correct rebate amount when required will cause the bonds of the issue to be arbitrage bonds, unless the Commissioner determines that the failure was not caused by willful neglect and the issuer promptly pays a penalty to the United States. If no bond of the issue is a private activity bond (other than a qualified 501(c)(3) bond), the penalty equals 50 percent of the rebate amount not paid when required to be paid, plus interest on that amount. Otherwise, the penalty equals 100 percent of the rebate amount not paid when required to be paid, plus interest on that amount.

(2) Interest on underpayments. Interest accrues at the underpayment rate under section 6621, beginning on the date the correct rebate amount is due and ending on the date 10 days before it is paid.

(3) Waivers of the penalty. The penalty is automatically waived if the rebate amount that the issuer failed to pay plus interest is paid within 180 days after discovery of the failure, unless, the Commissioner determines that the failure was due to willful neglect, or the issue is under examination by the Commissioner at any time during the period beginning on the date the failure first occurred and ending on the date 90 days after the receipt of the rebate amount. Generally, extensions of this 180-day period and waivers of the penalty in other cases will be granted by the Commissioner only in unusual circumstances.

(4) Application to alternative penalty under §1.148-7. Paragraphs (h) (1), (2), and (3) of this section apply to failures to pay penalty payments under §1.148-7 (alternative penalty amounts) by substituting alternative penalty amounts for rebate amount and the last day of each spending period for computation date.

(i) Recovery of overpayment of rebate-(1) In general. An issuer may recover an overpayment for an issue of tax-exempt bonds by establishing to the satisfaction of the Commissioner that the overpayment occurred. An overpayment is the excess of the amount paid to the United States for an issue under section 148 over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested.

(2) Limitations on recovery. (i) An overpayment may be recovered only to the extent that a recovery on the date that it is first requested would not result in an additional rebate amount if that date were treated as a computation date.

(ii) Except for overpayments of penalty in lieu of rebate under section 148(f)(4)(C)(vii) and §1.148-7(k), an overpayment of less than $5,000 may not be recovered before the final computation date.

(j) Examples. The provisions of this section may be illustrated by the following examples.

Example 1. Calculation and payment of rebate for a fixed yield issue. (i) Facts. On January 1, 1994, City A issues a fixed yield issue and invests all the sale proceeds of the issue ($49 million). There are no other gross proceeds. The issue has a yield of 7.0000 percent per year compounded semiannually (computed on a 30 day month/360 day year basis). City A receives amounts from the investment and immediately expends them for the governmental purpose of the issue as follows: --------------------- Date Amount --------------------- 2/1/1994 .. $3,000,000 4/1/1994 ... 5,000,000 6/1/1994 .. 14,000,000 9/1/1994 .. 20,000,000 7/1/1995 .. 10,000,000 ---------------------

(ii) First computation date. (A) City A selects a bond year ending on January 1, and thus the first required computation date is January 1, 1999. The rebate amount as of this date is computed by determining the future value of the receipts and the payments for the investment. The compounding interval is each 6- month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts, plus the computation credit, as of January 1, 1999, is: -- Date Receipts (payments) FV (7.0000 percent) -- 1/1/1994 .... ($49,000,000) ...... ($69,119,339) 2/1/1994 .... 3,000,000 .... 4,207,602 4/1/1994 .... 5,000,000 .... 6,932,715 6/1/1994 .... 14,000,000 .... 19,190,277 9/1/1994 .... 20,000,000 .... 26,947,162 1/1/1995 .... (1,000) .... (1,317) 7/1/1995 .... 10,000,000 .... 12,722,793 1/1/1996 .... (1,000) .... (1,229) Rebate amount (1/01/1999) .. -------------------- .... 878,664 --

(B) City A pays 90 percent of the rebate amount ($790,798) to the United States within 60 days of January 1, 1999.

(iii) Second computation date. (A) On the next required computation date, January 1, 2004, the future value of the payments and receipts is: -- Date Receipts (payments) FV (7.0000 percent) -- 1/1/1999 .... $878,664 .... $1,239,442 Rebate amount (1/01/2004) .. -------------------- .... 1,239,442 --

(B) As of this computation date, the future value of the payment treated as made on January 1, 1999, is $1,115,499, which equals at least 90 percent of the rebate amount as of this computation date ($1,239,442 0.9), and thus no additional rebate payment is due as of this date.

(iv) Final computation date. (A) On January 1, 2009, City A redeems all the bonds, and thus this date is the final computation date. The future value of the receipts and payments as of this date is: --- Date Receipts (payments) FV (7.0000 percent) --- 1/1/2004 .... $1,239,442 .... $1,748,355 1/1/2009 .... (1,000) .... (1,000) Rebate amount (1/01/2009) .. -------------------- .... 1,747,355 ---

(B) As of this computation date, the future value of the payment made on January 1, 1999, is $1,573,521 and thus an additional rebate payment of $173,834 is due. This payment reflects the future value of the 10 percent unpaid portion, and thus would not be owed had the issuer paid the full rebate amount as of any prior computation date.

Example 2. Calculation and payment of rebate for a variable yield issue. (i) Facts. On July 1, 1994, City B issues a variable yield issue and invests all of the sale proceeds of the issue ($30 million). There are no other gross proceeds. As of July 1, 1999, there are nonpurpose investments allocated to the issue. Prior to July 1, 1999, City B receives amounts from nonpurpose investments and immediately expends them for the governmental purpose of the issue as follows: ---------------------- Date Amount ---------------------- 8/1/1994 ... $5,000,000 7/1/1995 .... 8,000,000 12/1/1995 .. 17,000,000 7/1/1999 ...... 650,000 ----------------------

(ii) First computation date. (A) City B treats the last day of the fifth bond year (July 1, 1999) as a computation date. The yield on the variable yield issue during the first computation period (the period beginning on the issue date and ending on the first computation date) is 6.0000 percent per year compounded semiannually. The value of the nonpurpose investments allocated to the issue as of July 1, 1999, is $3 million. The rebate amount as of July 1, 1999, is computed by determining the future value of the receipts and the payments for the nonpurpose investments. The compounding interval is each 6-month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts and of the computation date credits as of July 1, 1999, is: --- Date Receipts (payments) FV (6.0000 percent) -- 7/1/1994 .... ($30,000,000) ...... ($40,317,491) 8/1/1994 .... 5,000,000 .... 6,686,560 7/1/1995 .... (1,000) .... (1,267) 7/1/1995 .... 8,000,000 .... 10,134,161 12/1/1995 .... 17,000,000 .... 21,011,112 7/1/1996 .... (1,000) .... (1,194) 7/1/1997 .... (1,000) .... (1,126) 7/1/1998 .... (1,000) .... (1,061) 7/1/1999 .... 3,000,000 .... 3,000,000 7/1/1999 .... 650,000 .... 650,000 7/1/1999 .... (1,000) .... (1,000) Rebate amount (7/01/1999) .. -------------------- .... 1,158,694 ---

(B) City B pays 90 percent of the rebate amount ($1,042,824.60) to the United States within 60 days of July 1, 1999.

(iii) Next computation date. (A) On July 1, 2004, City B redeems all of the bonds. Thus, the next computation date is July 1, 2004. On July 30, 1999, City B chose to compute rebate for periods following the first computation period by treating the end of each fifth bond year as a computation date. The yield during the second computation period is 5.0000 percent per year compounded semiannually. The computation of the rebate amount as of this date reflects the value of the nonpurpose investments allocated to the issue at the end of the prior computation period. On July 1, 2004, City B sells those nonpurpose investments for $3,925,000 and expends that amount for the governmental purpose of the issue.

(B) As of July 1, 2004, the future value of the rebate amount computed as of July 1, 1999, and of all other payments and receipts is:

Date	Receipts (payments)	FV (5.0000 percent)
7/1/1999	$1,158,694	$1,483,226
7/1/1999	(3,000,000)	(3,840,254)
7/1/2000	(1,000)	(1,218)
7/1/2001	(1,000)	(1,160)
7/1/2002	(1,000)	(1,104)
7/1/2003	(1,000)	(1,051)
7/1/2004	(2,000)	(2,000)
7/1/2004	3,925,000	3,925,000
		1,561,439

(C) As of this computation date, the future value of the payment made on July 1, 1999, is $1,334,904 and thus an additional rebate payment of $226,535 is due.

(k) Bona fide debt service fund exception. Under section 148(f)(4)(A), the rebate requirement does not apply to amounts in certain bona fide debt service funds. An issue with an average annual debt service that is not in excess of $2,500,000 may be treated as satisfying the $100,000 limitation in section 148(f)(4)(A)(ii).

§1.148-4 Yield on an issue of bonds.

(a) In general. The yield on an issue of bonds is used to apply investment yield restrictions under section 148(a) and to compute rebate liability under section 148(f). Yield is computed under the economic accrual method using any consistently applied compounding interval of not more than one year. A short first compounding interval and a short last compounding interval may be used. Yield is expressed as an annual percentage rate that is calculated to at least four decimal places (e.g., 5.2525 percent). Other reasonable, standard financial conventions, such as the 30 days per month/360 days per year convention, may be used in computing yield but must be consistently applied. The yield on an issue that would be a purpose investment (absent section 148(b)(3)(A)) is equal to the yield on the conduit financing issue that financed that purpose investment. The Commissioner may permit issuers of qualified mortgage bonds or qualified student loan bonds to use a single yield for two or more issues.

(b) Computing yield on a fixed yield issue-(1) In general-(i) Yield on an issue. The yield on a fixed yield issue is the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments of principal, interest, and fees for qualified guarantees on the issue and amounts reasonably expected to be paid as fees for qualified guarantees on the issue, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price of bonds of the issue as of the issue date. Further, payments include certain amounts properly allocable to a qualified hedge. Yield on a fixed yield issue is computed as of the issue date

and is not affected by subsequent unexpected events, except to the extent provided in paragraphs (b)(4) and (h)(3) of this section.

(ii) Yield on a bond. Yield on a fixed yield bond is computed in the same manner as yield on a fixed yield issue.

(2) Yield on certain fixed yield bonds subject to mandatory or contingent early redemption-(i) In general. The yield on a fixed yield issue that includes a bond subject to mandatory early redemption or expected contingent redemption is computed by treating that bond as redeemed on its reasonably expected early redemption date for an amount equal to its value on that date. Reasonable expectations are determined on the issue date. A bond is subject to mandatory early redemption if it is unconditionally payable in full before its final maturity date. A bond is subject to a contingent redemption if it must be, or is reasonably expected to be, redeemed prior to final maturity upon the occurrence of a contingency. A contingent redemption is taken into account only if the contingency is reasonably expected to occur, in which case the date of occurrence of the contingency must be reasonably estimated. For example, if bonds are reasonably expected to be redeemed early using excess revenues from general or special property taxes or benefit assessments or similar amounts, the reasonably expected redemption schedule is used to determine yield. For purposes of this paragraph (b)(2)(i), excess proceeds calls for issues for which the requirements of §1.148-2(e) (2) or (3) are satisfied, calamity calls, and refundings do not cause a bond to be subject to early redemption. The value of a bond is determined under paragraph (e) of this section.

(ii) Substantially identical bonds subject to mandatory early redemption. If substantially identical bonds of an issue are subject to specified mandatory redemptions prior to final maturity (e.g., a mandatory sinking fund redemption requirement), yield on that issue is computed by treating those bonds as redeemed in accordance with the redemption schedule for an amount equal to their value. Generally, bonds are substantially identical if the stated interest rate, maturity, and payment dates are the same. In computing the yield on an issue containing bonds described in this paragraph (b)(2)(ii), each of those bonds must be treated as redeemed at its present value, unless the stated redemption price at maturity of the bond does not exceed the issue price of the bond by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of years to the weighted average maturity date of the substantially identical bonds, in which case each of those bonds must be treated as redeemed at its outstanding stated principal amount, plus accrued, unpaid interest. Weighted average maturity is determined by taking into account the mandatory redemption schedule.

(3) Yield on certain fixed yield bonds subject to optional early redemption-(i) In general. If a fixed yield bond is subject to optional early redemption and is described in paragraph (b)(3)(ii) of this section, the yield on the issue containing the bond is

computed by treating the bond as redeemed at its stated redemption price on the optional redemption date that would produce the lowest yield on the issue.

(ii) Fixed yield bonds subject to special yield calculation rule. A fixed yield bond is described in this paragraph (b)(3)(ii) only if it-

(A) Is subject to optional redemption within five years of the issue date, but only if the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on that issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption;

(B) Is issued at an issue price that exceeds the stated redemption price at maturity by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of complete years to the first optional redemption date for the bond; or

(C) Bears interest at increasing interest rates (i.e., a stepped coupon bond).

(4) Yield recomputed upon transfer of certain rights associated with the bond. For purposes of §1.148-3, as of the date of any transfer, waiver, modification, or similar transaction (collectively, a transfer) of any right that is part of the terms of a bond or is otherwise associated with a bond (e.g., a redemption right), in a transaction that is separate and apart from the original sale of the bond, the issue is treated as if it were retired and a new issue issued on the date of the transfer (reissued). The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the date of the transfer. In computing yield on the new issue, any amounts received by the issuer as consideration for the transfer are taken into account.

(5) Examples. The provisions of this paragraph (b) may be illustrated by the following examples.

Example 1. No early call-(i) Facts. On January 1, 1994, City A issues an issue consisting of four identical fixed yield bonds. The stated final maturity date of each bond is January 1, 2004, and no bond is subject to redemption before this date. Interest is payable on January 1 of each year at a rate of 6.0000 percent per year on the outstanding principal amount. The total stated principal amount of the bonds is $20 million. The issue price of the bonds $20,060,000.

(ii) Computation. The yield on the issue is computed by treating the bonds as retired at the stated maturity under the general rule of §1.148-4(b)(1). The bonds are treated as redeemed for their stated redemption prices. The yield on the issue is 5.8731 percent per year compounded semiannually, computed as follows: --- Date Payments PV (5.8731 percent) -- 1/1/1995 .... $1,200,000 .... $1,132,510 1/1/1996 ..... 1,200,000 .... 1,068,816 1/1/1997 ..... 1,200,000 .... 1,008,704 1/1/1998 ..... 1,200,000 .... 951,973 1/1/1999 ..... 1,200,000 .... 898,433 1/1/2000 ..... 1,200,000 .... 847,903 1/1/2001 ..... 1,200,000 .... 800,216 1/1/2002 ..... 1,200,000 .... 755,210 1/1/2003 1,200,000

.... 712,736 1/1/2004 .... 21,200,000 .... 11,883,498 ----------- .... 20,060,000 ---

Example 2. Mandatory calls. (i) Facts. The facts are the same as in Example 1. In this case, however, the bonds are subject to mandatory sinking fund redemption on January 1 of each year, beginning January 1, 2001. On each sinking fund redemption date, one of the bonds is chosen by lottery and is required to be redeemed at par plus accrued interest.

(ii) Computation. Because the bonds are subject to specified redemptions, yield on the issue is computed by treating the bonds as redeemed in accordance with the redemption schedule under §1.148-4(b)(2)(ii). Because the bonds are not sold at a discount, the bonds are treated as retired at their stated redemption prices. The yield on the issue is 5.8678 percent per year compounded semiannually, computed as follows: --- Date Payments PV (5.8678 percent) --- 1/1/1995 .... $1,200,000 .... $1,132,569 1/1/1996 ..... 1,200,000 .... 1,068,926 1/1/1997 ..... 1,200,000 .... 1,008,860 1/1/1998 ..... 1,200,000 .... 952,169 1/1/1999 ..... 1,200,000 .... 898,664 1/1/2000 ..... 1,200,000 .... 848,166 1/1/2001 ..... 6,200,000 .... 4,135,942 1/1/2002 ..... 5,900,000 .... 3,714,650 1/1/2003 ..... 5,600,000 .... 3,327,647 1/1/2004 ..... 5,300,000 .... 2,972,407 ----------- .... $20,060,000 ---

Example 3. Optional early call. (i) Facts. On January 1, 1994, City C issues an issue consisting of three bonds. Each bond has a stated principal amount of $10 million dollars and is issued for par. Bond X bears interest at 5 percent per year and matures on January 1, 1999. BondY bears interest at 6 percent per year and matures on January 1, 2002. Bond Z bears interest at 7 percent per year and matures on January 1, 2004. Bonds Y and Z are callable by the issuer at par plus accrued interest after December 31, 1998.

(ii) Computation. (A) The yield on the issue computed as if each bond is outstanding to its maturity is 6.0834 percent per year compounded semiannually, computed as follows: --- Date Payments PV (6.0834 percent) --- 1/1/1995 .... $1,800,000 .... $1,695,299 1/1/1996 ..... 1,800,000 .... 1,596,689 1/1/1997 ..... 1,800,000 .... 1,503,814 1/1/1998 ..... 1,800,000 .... 1,416,342 1/1/1999 .... 11,800,000 .... 8,744,830 1/1/2000 ..... 1,300,000 .... 907,374 1/1/2001 ..... 1,300,000 .... 854,595 1/1/2002 .... 11,300,000 .... 6,996,316 1/1/2003 .... 700,000 .... 408,190 1/1/2004 .... 10,700,000 .... 5,876,551 ----------- .... 30,000,000 ---

(B) The yield on the issue computed as if all bonds are called at the earliest date for redemption is 5.9126 percent per year compounded semiannually, computed as follows: --- Date Payments PV (5.9126 percent) --- 1/1/1995 .... $1,800,000 .... $1,698,113 1/1/1996 ..... 1,800,000 .... 1,601,994 1/1/1997 ..... 1,800,000 .... 1,511,315 1/1/1998 ..... 1,800,000 .... 1,425,769 1/1/1999 .... 31,800,000 .... 23,762,809 ----------- .... 30,000,000 ---

(C) Because the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on the issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption, each bond is treated as redeemed on the date that would produce the lowest yield for the issue. The lowest yield on the issue would result from a redemption of all the bonds on January 1, 1999. Thus, the yield on the issue is 5.9126 percent per year compounded semiannually.

(c) Computing yield on a variable yield issue-(1) In general. The yield on a variable yield issue is computed separately for each computation period. The yield for each computation period is the discount rate that, when used in computing the present value as of the first day of the computation period of all the payments of principal and interest and fees for qualified guarantees that are attributable to the computation period, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price (or deemed issue price, as determined in paragraph (c)(2)(iv) of this section) of the bonds of the issue as of the first day of the computation period. The yield on a variable yield bond is computed in the same manner as the yield on a variable yield issue. Except as provided in paragraph (c)(2) of this section, yield on any fixed yield bond in a variable yield issue is computed in the same manner as the yield on a fixed yield issue as provided in paragraph (b) of this section.

(2) Payments on bonds included in yield for a computation period-(i) Payments in general. The payments on a bond that are attributable to a computation period include any amounts actually paid during the period for principal on the bond. Payments also include any amounts paid during the current period both for interest accruing on the bond during the current period and for interest accruing during the prior period that was included in the deemed issue price of the bond as accrued unpaid interest at the start of the current period under this paragraph (c)(2). Further, payments include any amounts properly allocable to fees for a qualified guarantee of the bond for the period and to any amounts properly allocable to a qualified hedge for the period.

(ii) Payments at actual redemption. If a bond is actually redeemed during a computation period, an amount equal to the greater of its value on the redemption date or the actual redemption price is a payment on the actual redemption date.

(iii) Payments for bonds outstanding at end of computation period. If a bond is outstanding at the end of a computation period, a payment equal to the bond's value is taken into account on the last day of that period.

(iv) Issue price for bonds outstanding at beginning of next computation period. A bond outstanding at the end of a computation period is treated as if it were immediately reissued on the next day for a deemed issue price equal to the value from the day before as determined under paragraph (c)(2)(iii) of this section.

(3) Example. The provisions of this paragraph (c) may be illustrated by the following example.

Example. On January 1, 1994, City A issues an issue of identical plain par bonds in an aggregate principal amount of $1,000,000. The bonds pay interest at a variable rate on each June 1 throughout the term of the issue. The entire principal amount of the bonds plus accrued, unpaid interest is payable on the final maturity date of January 1, 2000. No bond year is selected. On June 1, 1994, 1995, 1996, 1997, and 1998, interest in the amounts of $30,000, $55,000, $57,000, $56,000, and $45,000 is paid on the bonds. From June 1, 1998, to January 1, 1999, $30,000 of interest accrues on the bonds. From January 1, 1999, to June 1, 1999, another $35,000 of interest accrues. On June 1, 1999, the issuer actually pays $65,000 of interest. On January 1, 2000, $1,000,000 of principal and $38,000 of accrued interest are paid. The payments for the computation period starting on the issue date and ending on January 1, 1999, include all annual interest payments paid from the issue date to June 1, 1998. Because the issue is outstanding on January 1, 1999, it is treated as redeemed on that date for amount equal to its value ($1,000,000 plus accrued, unpaid interest of $30,000 under paragraph (e)(1) of this section). Thus, $1,030,000 is treated as paid on January 1, 1999. The issue is then treated as reissued on January 1, 1999, for $1,030,000. The payments for the next computation period starting on January 1, 1999, and ending on January 1, 2000, include the interest actually paid on the bonds during that period ($65,000 on June 1, 1999, plus $38,000 paid on January 1, 2000). Because the issue was actually redeemed on January 1, 2000, an amount equal to its stated redemption price is also treated as paid on January 1, 2000.

(d) Conversion from variable yield issue to fixed yield issue. As of the first day on which a variable yield issue would qualify as a fixed yield issue if it were newly issued on that date (a conversion date), that issue is treated as if it were reissued as a fixed yield issue on the conversion date. The redemption price of the variable yield issue and the issue price of the fixed yield issue equal the aggregate values of all the bonds on the conversion date. Thus, for example, for plain par bonds (e.g., tender bonds), the deemed issue price would be the outstanding principal amount, plus accrued unpaid interest. If the conversion date occurs on a date other than a computation date, the issuer may continue to treat the issue as a variable yield issue until the next computation date, at which time it must be treated as converted to a fixed yield issue.

(e) Value of bonds-(1) Plain par bonds. Except as otherwise provided, the value of a plain par bond is its outstanding stated principal amount, plus accrued unpaid interest. The value of a plain par bond that is actually redeemed or treated as redeemed is its stated redemption price on the redemption date, plus accrued, unpaid interest.

(2) Other bonds. The value of a bond other than a plain par bond on a date is its present value on that date. The present value of a bond is computed under the economic accrual method taking into account all the unconditionally payable payments of principal, interest, and fees for a qualified guarantee to be paid on or after that date and using the yield on the bond as the discount rate, except that for purposes of §1.148-6(b)(2) (relating to the universal cap), these values may be determined by consistently using the yield on the issue of which the bonds are a part. To determine yield on fixed yield bonds, see paragraph (b)(1) of this section. The rules contained in paragraphs (b)(2) and (b)(3) of this section apply for this purpose. In the case of bonds described in paragraph (b)(2)(ii) of this section, the present value of those bonds on any date is computed using the yield to the final

maturity date of those bonds as the discount rate. In determining the present value of a variable yield bond under this paragraph (e)(2), the initial interest rate on the bond established by the interest index or other interest rate setting mechanism is used to determine the interest payments on that bond.

(f) Qualified guarantees-(1) In general. Fees properly allocable to payments for a qualified guarantee for an issue (as determined under paragraph (f)(6) of this section) are treated as additional interest on that issue under section 148. A guarantee is a qualified guarantee if it satisfies each of the requirements of paragraphs (f)(2) through (f)(4) of this section.

(2) Interest savings. As of the date the guarantee is obtained, the issuer must reasonably expect that the present value of the fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee. For this purpose, present value is computed using the yield on the issue, determined with regard to guarantee payments, as the discount rate.

(3) Guarantee in substance. The arrangement must create a guarantee in substance. The arrangement must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments, such as payments for principal and interest, redemption prices, or tender prices, on the guaranteed bonds. Reasonable procedural or administrative requirements of the guarantee do not cause the guarantee to be conditional. In the case of a guarantee against failure to remarket a qualified tender bond, commercially reasonable limitations based on credit risk, such as limitations on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor, do not cause the guarantee to be conditional. The guarantee may be in any form. The guarantor may not be a co-obligor. Thus, the guarantor must not expect to make any payments other than under a direct-pay letter of credit or similar arrangement for which the guarantor will be reimbursed immediately. The guarantor and any related parties together must not use more than 10 percent of the proceeds of the portion of the issue allocable to the guaranteed bonds.

(4) Reasonable charge-(i) In general. Fees for a guarantee must not exceed a reasonable, arm's-length charge for the transfer of credit risk. In complying with this requirement, the issuer may not rely on the representations of the guarantor.

(ii) Fees for services other than transfer of credit risk must be separately stated. A fee for a guarantee must not include any payment for any direct or indirect services other than the transfer of credit risk, unless the compensation for those other services is separately stated, reasonable, and excluded from the guarantee fee. Fees for the transfer of credit risk include fees for the guarantor's overhead and other costs relating to the transfer of credit risk. For example, a fee includes payment for services other than transfer of credit risk if-

(A) It includes payment for the cost of underwriting or remarketing bonds or for the cost of insurance for casualty to bond-financed property;

(B) It is refundable upon redemption of the guaranteed bond before the final maturity date and the amount of the refund would exceed the portion of the fee that had not been earned; or

(C) The requirements of §1.148-2(e)(2) (relating to temporary periods for capital projects) are not satisfied, and the guarantor is not reasonably assured that the bonds will be repaid if the project to be financed is not completed.

(5) Guarantee of purpose investments. Except for guarantees of qualified mortgage loans and qualified student loans, a guarantee of payments on a purpose investment is a qualified guarantee of the issue if all payments on the purpose investment reasonably coincide with payments on the related bonds and the payments on the purpose investment are unconditionally payable no more than 6 months before the corresponding interest payment and 12 months before the corresponding principal payments on the bonds. This paragraph (f)(5) only applies if, in addition to satisfying the other requirements of this paragraph (f), the guarantee is, in substance, a guarantee of the bonds allocable to that purpose investment and to no other bonds except for bonds that are equally and ratably secured by purpose investments of the same conduit borrower.

(6) Allocation of qualified guarantee payments-(i) In general. Payments for a qualified guarantee must be allocated to bonds and to computation periods in a manner that properly reflects the proportionate credit risk for which the guarantor is compensated. Proportionate credit risk for bonds that are not substantially identical may be determined using any reasonable, consistently applied method. For example, this risk may be based on the ratio of the total principal and interest paid and to be paid on a guaranteed bond to the total principal and interest paid and to be paid on all bonds of the guaranteed issue. An allocation method generally is not reasonable, for example, if a substantial portion of the fee is allocated to the construction portion of the issue and a correspondingly insubstantial portion is allocated to the later years covered by the guarantee. Reasonable letter of credit set up fees may be allocated ratably during the initial term of the letter of credit. Upon an early redemption of a variable yield bond, fees otherwise allocable to the period after the redemption are allocated to remaining outstanding bonds of the issue or, if none remain outstanding, to the period before the redemption.

(ii) Safe harbor for allocation of qualified guarantee fees for variable yield issues. An allocation of non-level payments for a qualified guarantee for variable yield bonds is treated as meeting the requirements of paragraph (f)(6)(i) of this section if, for each bond year for which the guarantee is in effect, an equal amount (or for any short bond year, a proportionate amount of the equal amount) is treated as paid as of the beginning of that bond year. The present value of the annual amounts must equal the fee for the guarantee allocated to that bond, with present value computed as of the first day the guarantee is in effect by using as the discount rate the yield on the variable yield bonds covered by the guarantee, determined without regard to any fee allocated under this paragraph (f)(6)(ii).

(7) Refund or reduction of guarantee payments. If as a result of an investment of proceeds of a refunding issue in a refunding escrow, there will be a reduction in, or refund of, payments for a guarantee (savings), the savings must be treated as a reduction in the payments on the refunding issue.

(g) Yield on certain mortgage revenue and student loan bonds. For purposes of section 148 and this section, section 143(g)(2)(C)(ii) applies to the computation of yield on an issue of qualified mortgage bonds or qualified veterans' mortgage bonds. For purposes of applying sections 148 and 143(g) to a variable yield issue of qualified mortgage bonds or qualified student loan bonds, the yield on that issue is computed over the term of the issue.

(h) Qualified hedging transactions-(1) In general. Payments made or received by an issuer under a qualified hedge (as defined in paragraph (h)(2) of this section) relating to bonds of an issue are taken into account (as provided in paragraph (h)(3) of this section) to determine the yield on the issue. Except as provided in paragraph (h)(4) of this section, the issue is treated as a variable yield issue. These hedging rules apply solely for purposes of section 148.

(2) Qualified hedge defined. A qualified hedge is a contract that satisfies each of the following requirements:

(i) Hedge-(A) In general. The contract is a hedge entered into primarily to reduce the issuer's risk of interest rate changes with respect to a borrowing. For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option.

(B) No significant investment element. A contract is not a hedge under paragraph (h)(2)(i)(A) of this section if it contains a significant investment element (i.e., an expected return). For example, variable rate bonds held by the issuer do not meet the requirements of this paragraph (h)(2)(i). A contract may contain a significant investment element if the payments under the contract do not correspond closely in time and amount to the interest payments on the bonds being hedged. For example, an interest rate swap generally contains a significant investment element if it requires any payments other than periodic payments, within the meaning of section 446 and the regulations thereunder (periodic payments) (e.g., an up-front payment for an off-market swap) before its termination date. Similarly, an interest rate cap generally contains a significant investment element if the cap rate is less than the on-market swap rate on the date the cap is entered into. For this purpose, the on-market swap rate is the single fixed rate for which the rate or index that is the subject of the cap could be swapped in an on-market interest rate swap that requires only periodic payments and that has a term equal to the term of the cap.

(ii) Parties. The contract is entered into between the issuer or the political subdivision on behalf of which the issuer issues the bonds (collectively referred to in this paragraph (h) as the issuer) and a provider that is not a related party (the hedge provider).

(iii) Hedged bonds. The hedge covers all of one or more groups of substantially identical bonds in the issue (i.e., all of the bonds having the same interest rate, maturity, and terms). If the hedge does not cover all interest payments on all of the substantially identical bonds being hedged, it must cover, in whole or in part, the same specific identifiable interest payments on each of the substantially identical bonds. Thus, for example, a qualified hedge may include a hedge of all or a pro rata portion of each interest payment on the variable rate bonds in an issue for the first five years following their issuance. For purposes of this paragraph (h), unless the context clearly requires otherwise, hedged bonds means the specific bonds or portions thereof (i.e., the specific interest payments) covered by a hedge.

(iv) Interest based. Changes in the value of the contract are based primarily on interest rate changes. For example, an interest rate swap or a futures contract on

Treasury securities may qualify. A commodity swap or an option on a commodity futures contract, however, is not a qualified hedge.

(v) Size. The contract does not hedge an amount larger than the issuer's risk with respect to interest rate changes on the hedged bonds.

(vi) Receipts. The payments to the issuer under the contract correspond closely, in both time and amount, to the specific interest payments being hedged on the hedged bonds.

(vii) Timing and duration. Payments do not begin to accrue under the contract on a date earlier than the sale date of the hedged bonds and do not accrue longer than the hedged interest payments on the hedged bonds.

(viii) Source of payments. Payments to the hedge provider are reasonably expected to be made from the same source of funds that, absent the hedge, would be reasonably expected to be used to pay principal and interest on the hedged bonds.

(ix) Identification. The hedge is identified by the actual issuer on its books and records maintained for the hedged bonds on or before the later of the date on which the parties enter into the contract or the issue date of the hedged bonds. The identification specifies the hedge provider, the terms of the hedge, and the hedged bonds. The identification contains sufficient detail to establish that the requirements of this paragraph (h)(2) and, if applicable, paragraph (h)(4) of this section are satisfied. The existence of the hedge is noted on all forms filed with the Internal Revenue Service for the issue after the date on which the hedge is entered into.

(3) Accounting for qualified hedges-(i) In general. Except as otherwise provided in paragraph (h)(4) of this section, payments made or received by the issuer under a qualified hedge are treated as payments made or received, as appropriate, on the hedged bonds that are taken into account in determining the yield on those bonds. These payments are reasonably allocated to the hedged bonds in the period to which the payments relate, as determined under paragraph (h)(3)(iii) of this section. Payments made or received by the issuer include payments deemed made or received when a contract is terminated or deemed terminated under this paragraph (h)(3). Payments reasonably allocable to the reduction of risk of interest rate changes and to the hedge provider's overhead under this paragraph (h) are included as payments made or received under a qualified hedge.

(ii) Exclusions from hedge. Payments for services or other items under the contract that are not expressly treated as payments under the qualified hedge under paragraph (h)(3)(i) of this section are not payments with respect to a qualified hedge.

(iii) Timing and allocation of payments. The period to which a payment made by the issuer relates is determined under general Federal income tax principles, including, without limitation, section 446 and the regulations thereunder on notional principal contracts, and adjusted as necessary to reflect the end of a computation period and the start of a new computation period. Except as provided in paragraph (h)(3)(iv) of this section, a payment received by the issuer is taken into account in the period that the interest payment that the payment hedges is required to be made.

(iv) Termination payments-(A) Termination defined. A termination of a qualified hedge includes any sale, assignment, or other disposition of the hedge by the issuer, or the acquisition by the issuer of an offsetting hedge. A deemed termination occurs when the hedged bonds are redeemed.

(B) General rule. A payment made or received by an issuer to terminate a qualified hedge, including gain or loss realized or deemed realized, is treated as a payment made or received on the hedged bonds, as appropriate. The payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge.

(C) Special rule for terminations when bonds are redeemed. Except as otherwise provided in this paragraph (h)(3)(iv)(C) and in paragraph (h)(3)(iv)(D) of this section, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the fair market value of the contract on the redemption date is treated as a termination payment made or received on that date. When hedged bonds are redeemed, any payment received by the issuer on termination of a hedge, including a termination payment or a deemed termination payment, reduces, but cannot exceed, the interest payments made by the issuer on the hedged bonds in the computation period ending on the termination date. The excess, if any, is reasonably allocated over the bond years in the immediately preceding computation period or periods to the extent necessary to eliminate the excess.

(D) Special rules for refundings. To the extent that the hedged bonds are redeemed using the proceeds of a refunding issue, the termination payment is accounted for under paragraph (h)(3)(iv)(B) by treating it as a payment on the refunding issue, rather than the hedged bonds. In addition, to the extent that the refunding issue, rather than the hedged bonds, has been redeemed, paragraph (h)(3)(iv)(C) applies to the termination payment by treating it as a payment on the redeemed refunding issue.

(4) Certain variable yield issues treated as fixed yield issues-(i) In general. Except as otherwise provided in paragraph (h)(4)(ii)(C) of this section, if the issuer of a variable yield issue enters into an interest rate swap that is a qualified hedge, the hedged bonds are treated as fixed yield bonds if-

(A) Start date. The date on which payments begin to accrue on the swap is not later than 15 days after the issue date of the hedged bonds;

(B) Maturity. The term of the swap is equal to the term of the hedged bonds or the entire period during which the hedged bonds bear interest at variable interest rates.

(C) No nonperiodic payments. Payments to be made or received under the swap are reasonably expected to correspond closely, in time and amount, to payments on the hedged bonds (i.e., no nonperiodic payments). Swap payments made within 15 days of the related payments on the hedged bonds generally so correspond.

(D) Notional principal amount. The notional principal amount used to compute both fixed and variable payments on the swap equals the principal amount of all the variable yield bonds in the issue.

(E) Payments and interest rate. Under the swap, the issuer makes level payments based on a fixed interest rate and receives payments based on a variable interest rate that is substantially the same as the interest rate on the hedged bonds. These interest rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge. For example, an objective 30-day tax-exempt variable rate index or other objective index (e.g., LIBOR, J.J. Kenney Index, PSA Municipal swap index) may be adjusted to correspond to an issuer's individual 30-day interest rate.

(ii) Accounting-(A) In general. If a hedged bond is treated as a fixed yield bond under this paragraph (h)(4), the fixed-rate payments made by the issuer on the swap are substituted for the actual interest payments on the hedged bonds for purposes of computing yield on that bond. For this purpose, the fixed-rate payments are the amounts determined by multiplying the notional principal amount by the fixed rate (i.e., the amount determined before netting the fixed and variable amounts due under the swap).

(B) Effect of termination generally. Except as otherwise provided in paragraph (h)(4)(ii)(C) of this section, for purposes of §1.148-3, as of the termination date of a qualified hedge covered by this paragraph (h)(4), the issue of which the hedged bonds are a part is treated as if it were reissued on the termination date. The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the termination date. In computing the yield on the new issue, any termination payment is accounted for under paragraph (h)(3)(iv) of this section, applied by treating the termination payment as made or received on the deemed new issue under this paragraph (h)(4)(ii)(B).

(C) Effect of early termination. If the swap is terminated or deemed terminated within 5 years after the issue date of the issue of which the hedged bonds are a part, the general rules under this paragraph (h)(4) do not apply, and, for purposes of §1.148-3, the hedged bonds are treated as variable yield bonds from the issue date.

(5) Authority of the Commissioner-(i) In general. A contract is not a qualified hedge if the Commissioner determines, based on all the facts and circumstances, that treating the contract as a qualified hedge would provide a material potential for arbitrage, or a principal purpose for entering into the contract is that arbitrage potential. For example, a contract that requires a substantial nonperiodic payment may constitute, in whole or part, an embedded loan, investment-type property, or other investment.

(ii) Other qualified hedges. The Commissioner, by publication of a revenue ruling or revenue procedure, may specify contracts that do not otherwise meet the requirements of paragraph (h)(2) of this section as qualified hedges.

(iii) Recomputation of yield. If an issuer enters into a hedge that is not properly identified or otherwise fails to meet the requirements of this section, the Commissioner may recompute the yield on the issue taking the hedge into account if the failure to take the hedge into account distorts that yield or otherwise fails to clearly reflect the economic substance of the transaction.

§1.148-5 Yield and valuation of investments.

(a) In general. This section provides rules for computing the yield and value of investments allocated to an issue for various purposes under section 148.

(b) Yield on an investment-(1) In general. Except as otherwise provided, the yield on an investment allocated to an issue is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The yield on an investment allocated to an issue is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. For this purpose, payments means amounts to be actually or constructively paid to acquire the investment, and receipts means amounts to be actually or constructively received from the investment, such as earnings and return of principal. The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue. For an issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds on which interest is paid semiannually, all regular monthly loan payments to be received during a semiannual debt service period may be treated as received at the end of that period. In addition, for any conduit financing issue, payments made by the conduit borrower are not treated as paid until the conduit borrower ceases to receive the benefit of earnings on those amounts.

(2) Yield on a separate class of investments-(i) In general. For purposes of the yield restriction rules of section 148(a) and §1.148-2, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, whether or not held concurrently, by treating those investments as a single investment. The yields on investments that are not within the same class are not blended.

(ii) Separate classes of investments. Each of the following is a separate class of investments-

(A) Each category of yield restricted purpose investment and program investment that is subject to a different definition of materially higher under §1.148-2(d)(2);

(B) Yield-restricted nonpurpose investments; and

(C) All other nonpurpose investments;

(iii) Permissive application of single investment rules to certain yield restricted investments for all purposes of section 148. Excluding those investments to which paragraph (b)(2)(iv) of this section applies, all yield restricted investments that are part of the same class may be treated as a single investment having a single yield, determined under this paragraph (b)(2), for all purposes of section 148.

(iv) Mandatory application of single investment rules for refunding escrows for all purposes of section 148. For all purposes of section 148, in computing the yield on yield restricted investments allocable to proceeds (i.e., sale proceeds, investment proceeds, and transferred proceeds) of a refunding issue that are held in one or more refunding escrows, the individual investments are treated as a single investment having a single yield, whether or not held concurrently. For example, this single investment includes both the individual investments allocable to sale and investment proceeds of a refunding issue that are held in one refunding escrow for a prior issue and the investments allocable to transferred proceeds of that refunding issue that are held in another refunding escrow.

(3) Investments to be held beyond issue's maturity or beyond temporary period. In computing the yield on investments allocable to an issue that are to be held beyond the reasonably expected redemption date of the issue, those investments are treated as sold for an amount equal to their value on that date. In computing the yield on investments that are held beyond an applicable temporary period under §1.148-2, for purposes of §1.148-2 those investments may be treated as purchased for an amount equal to their fair market value as of the end of the temporary period.

(4) Consistent redemption assumptions on purpose investments. The yield on purpose investments allocable to an issue is computed using the same redemption assumptions used to compute the yield on the issue. Yield on purpose investments allocable to an issue of qualified mortgage bonds and qualified veterans' mortgage bonds must be determined in a manner that is consistent with, and using the assumptions required by, section 143(g)(2)(B).

(5) Student loan special allowance payments included in yield. Except as provided in §1.148-11(e), the yield on qualified student loans is computed by including as receipts any special allowance payments made by the Secretary of Education pursuant to section 438 of the Higher Education Act of 1965.

(c) Yield reduction payments to the United States-(1) In general. In determining the yield on an investment to which this paragraph (c) applies, any amount paid to the United States in accordance with this paragraph (c), including a rebate amount, is treated as a payment for that investment that reduces the yield on that investment.

(2) Manner of payment-(i) In general. Except as otherwise provided in paragraph (c)(2)(ii) of this section, an amount is paid under this paragraph (c) if it is paid to the United States at the same time and in the same manner as rebate amounts are required to be paid or at such other time or in such manner as the Commissioner may prescribe. The provisions of §1.148-3(i) apply to payments made under this paragraph (c).

(ii) Special rule for purpose investments. For purpose investments allocable to an issue-

(A) No amounts are required to be paid to satisfy this paragraph (c) until the earlier of the end of the tenth bond year after the issue date of the issue or 60 days after the date on which the issue is no longer outstanding; and

(B) For payments made prior to the date on which the issue is retired, the issuer need not pay more than 75 percent of the amount otherwise required to be paid as of the date to which the payment relates.

(3) Applicability of special yield reduction rule-(i) Covered investments. This paragraph (c) applies to-

(A) Nonpurpose investments allocable to proceeds of an issue that qualified for one of the temporary periods available for capital projects, restricted working capital expenditures, pooled financings, or investment proceeds under paragraphs §1.148-2 (e)(2), (e)(3), (e)(4), or (e)(6) of this section, respectively;

(B) Investments allocable to a variable yield issue during any computation period in which at least 5 percent of the value of the issue is represented by variable yield bonds, unless the issue is an issue of hedge bonds (as defined in section 149(g)(3)(A));

(C) Nonpurpose investments allocable to transferred proceeds of-

(1) A current refunding issue to the extent necessary to reduce the yield on those investments to satisfy yield restrictions under section 148(a); or

(2) An advance refunding issue to the extent that investment of the refunding escrows allocable to the proceeds, other than transferred proceeds, of the refunding issue in zero-yielding nonpurpose investments is insufficient to satisfy yield restrictions under section 148(a);

(D) Purpose investments allocable to qualified student loans under a program described in section 144(b)(1)(A);

(E) Nonpurpose investments allocable to gross proceeds of an issue in a fund that, except for its failure to satisfy the size limitation in §1.148-2(f)(2)(ii), would qualify as a reasonably required reserve or replacement fund, but only to the extent that-

(1) The value of the nonpurpose investments in the fund is not greater than 15 percent of the stated principal amount of the issue, as computed under §1.148-2(f)(2)(ii), or

(2) The amounts in the fund (other than investment earnings) are not reasonably expected to be used to pay debt service on the issue (e.g., a reserve fund for a revolving fund loan program);

(F) Nonpurpose investments allocated to replacement proceeds of a refunded issue as a result of the application of the universal cap to amounts in a refunding escrow (see §1.148-11(c)(1)(ii)); and

(G) Investments described in §1.148-11(f).

(ii) Exception to yield reduction payments rule for advance refunding issues. Paragraph (c)(1) of this section does not apply to investments allocable to gross proceeds of an advance refunding issue, other than transferred proceeds to which paragraph (c)(3)(i)(C) of this section applies and replacement proceeds to which paragraph (c)(3)(i)(F) of this section applies.

(d) Value of investments-(1) In general. Except as otherwise provided, the value of an investment (including a payment or receipt on the investment) on a date must be determined using one of the following valuation methods consistently for all purposes of section 148 to that investment on that date:

(i) Plain par investment-outstanding principal amount. A plain par investment may be valued at its outstanding stated principal amount, plus any accrued unpaid interest on that date.

(ii) Fixed rate investment-present value. A fixed rate investment may be valued at its present value on that date.

(iii) Any investment-fair market value. An investment may be valued at its fair market value on that date.

(2) Mandatory valuation of yield restricted investments at present value. Any yield restricted investment must be valued at present value. For example, a purpose investment or an investment allocable to gross proceeds in a refunding escrow after the expiration of the initial temporary period must be valued at present value. See, however, paragraph (b)(3) of this section.

(3) Mandatory valuation of certain investments at fair market value-(i) In general. Except as provided in paragraphs (d)(2), (d)(3)(ii), and (d)(4) of this section, an investment must be valued at fair market value on the date that it is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or deemed disposition. For example, if an issuer deposits existing investments into a sinking fund for an issue, those investments must be valued at fair market value as of the date first deposited into the fund.

(ii) Exception to fair market value requirement for transferred proceeds allocations, universal cap allocations, and commingled funds. This paragraph (d)(3) does not apply if the investment is allocated to an issue or ceases to be allocated to an issue as a result of the transferred proceeds allocation rule under §1.148-9(b) or the universal cap rule under §1.148-6(b)(2). In addition, this paragraph (d)(3) does not apply to investments in a commingled fund (other than a bona fide debt service fund) unless it is a commingled fund described in §1.148-6(e)(5)(iii).

(4) Special transition rule for transferred proceeds. The value of a nonpurpose investment that is allocated to transferred proceeds of a refunding issue on a transfer date may not exceed the value of that investment on the transfer date used for purposes of applying the arbitrage restrictions to the refunded issue.

(5) Definition of present value of an investment. Except as otherwise provided, present value of an investment is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The present value of an investment on a date is equal to the present value of all unconditionally payable receipts to be received from and payments to be paid for the investment after that date, using the yield on the investment as the discount rate.

(6) Definition of fair market value-(i) In general. The fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction. Fair market value generally is determined on the date on which a contract to purchase or sell the nonpurpose investment becomes binding (i.e., the trade date rather than the settlement date). Except as otherwise provided in this paragraph (d)(6), an investment that is not of a type traded on an established securities market, within the meaning of section 1273,

is rebuttably presumed to be acquired or disposed of for a price that is not equal to its fair market value. The fair market value of a United States Treasury obligation that is purchased directly from the United States Treasury is its purchase price.

(ii) Safe harbor for establishing fair market value for certificates of deposit. This paragraph (d)(6)(ii) applies to a certificate of deposit that has a fixed interest rate, a fixed payment schedule, and a substantial penalty for early withdrawal. The purchase price of such a certificate of deposit is treated as its fair market value on the purchase date if the yield on the certificate of deposit is not less than-

(A) The yield on reasonably comparable direct obligations of the United States; and

(B) The highest yield that is published or posted by the provider to be currently available from the provider on reasonably comparable certificates of deposit offered to the public.

(iii) Safe harbor for establishing fair market value for guaranteed investment contracts. The purchase price of a guaranteed investment contract is treated as its fair market value on the purchase date if-

(A) The issuer makes a bona fide solicitation for a specified guaranteed investment contract and receives at least three bona fide bids from providers that have no material financial interest in the issue (e.g., as underwriters or brokers);

(B) The issuer purchases the highest-yielding guaranteed investment contract for which a qualifying bid is made (determined net of broker's fees);

(C) The yield on the guaranteed investment contract (determined net of broker's fees) is not less than the yield then available from the provider on reasonably comparable guaranteed investment contracts, if any, offered to other persons from a source of funds other than gross proceeds of tax-exempt bonds;

(D) The determination of the terms of the guaranteed investment contract takes into account as a significant factor the issuer's reasonably expected drawdown schedule for the amounts to be invested, exclusive of amounts deposited in debt service funds and reasonably required reserve or replacement funds;

(E) The terms of the guaranteed investment contract, including collateral security requirements, are reasonable; and

(F) The obligor on the guaranteed investment contract certifies the administrative costs that it is paying (or expects to pay) to third parties in connection with the guaranteed investment contract.

(e) Administrative costs of investments-(1) In general. Except as otherwise provided in this paragraph (e), an allocation of gross proceeds of an issue to a payment or a receipt on an investment is not adjusted to take into account any costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment (administrative costs). Thus, these administrative costs generally do not increase the payments for, or reduce the receipts from, investments.

(2) Qualified administrative costs on nonpurpose investments-(i) In general. In determining payments and receipts on nonpurpose investments, qualified administrative costs are taken into account. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments. Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. General overhead costs and similar indirect costs of the issuer such as employee salaries and office expenses and costs associated with computing the rebate amount under section 148(f) are not qualified administrative costs. In general, administrative costs are not reasonable unless they are comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than gross proceeds of tax-exempt bonds.

(ii) Special rule for administrative costs of nonpurpose investments in certain regulated investment companies and commingled funds. Qualified administrative costs include all reasonable administrative costs, without regard to the limitation on indirect costs under paragraph (e)(2)(i) of this section, incurred by:

(A) Regulated investment companies. A publicly offered regulated investment company (as defined in section 67(c)(2)(B)); and

(B) External commingled funds. A commingled fund in which the issuer and any related parties do not own more than 10 percent of the beneficial interest in the fund.

(iii) Special rule for guaranteed investment contracts. For a guaranteed investment contract, a broker's commission paid on behalf of either an issuer or the provider is not a qualified administrative cost to the extent that the commission exceeds 0.05 percent of the amount reasonably expected to be invested per year. This paragraph (e)(2)(iii) does not apply to an issue that satisfies section 148(f)(4)(D)(i).

(3) Qualified administrative costs on purpose investments-(i) In general. In determining payments and receipts on purpose investments, qualified administrative costs described in this paragraph (e)(3) paid by the conduit borrower are taken into account. Thus, these costs increase the payments for, or decrease the receipts from, the purpose investments. This rule applies even if those payments merely reimburse the issuer. Although the actual payments by the conduit borrower may be made at any time, for this purpose, a pro rata portion of each payment made by a conduit borrower is treated as a reimbursement of reasonable administrative costs, if the present value of those payments does not exceed the present value of the reasonable administrative costs paid by the issuer, using the yield on the issue as the discount rate.

(ii) Definition of qualified administrative costs of purpose investments-(A) In general. Except as otherwise provided in this paragraph (e)(3)(ii), qualified administrative costs of a purpose investment means-

(1) Costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment; and

(2) Costs of issuing, carrying, or repaying the issue, and any underwriters' discount.

(B) Limitation on program investments. For a program investment, qualified administrative costs include only those costs described in paragraph (e)(3)(ii)(A)(2) of this section.

§1.148-6 General allocation and accounting rules.

(a) In general-(1) Reasonable accounting methods required. An issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue.

(2) Bona fide deviations from accounting method. An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes may include special State law restrictions imposed on specific funds or actions to avoid grant forfeitures.

(b) Allocation of gross proceeds to an issue-(1) One-issue rule and general ordering rules. Except as otherwise provided, amounts are allocable to only one issue at a time as gross proceeds, and if amounts simultaneously are proceeds of one issue and replacement proceeds of another issue, those amounts are allocable to the issue of which they are proceeds. Amounts cease to be allocated to an issue as proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are allocated to transferred proceeds of another issue, or cease to be allocated to that issue at retirement of the issue or under the universal cap of paragraph (b)(2) of this section. Amounts cease to be allocated to an issue as replacement proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are no longer used in a manner that causes those amounts to be replacement proceeds of that issue, or cease to be allocated to that issue because of the retirement of the issue or the application of the universal cap under paragraph (b)(2) of this section. Amounts that cease to be allocated to an issue as gross proceeds are eligible for allocation to another issue. Under §1.148-10(a), however, the rules in this paragraph (b)(1) do not apply in certain cases involving abusive arbitrage devices.

(2) Universal cap on value of nonpurpose investments allocated to an issue-(i) Application. The rules in this paragraph (b)(2) provide an overall limitation on the amount of gross proceeds allocable to an issue. Although the universal cap generally may be applied at any time in the manner described in this paragraph (b)(2), it need not be applied on any otherwise required date of application if its application on that date would not result in a reduction or reallocation of gross proceeds of an issue. For this purpose, if an issuer reasonably expects as of the issue date that the universal cap will not reduce the amount of gross proceeds allocable to the issue during the term of the issue, the universal cap need not be applied on any date on which an issue actually has all of the following characteristics-

(A) No replacement proceeds are allocable to the issue, other than replacement proceeds in a bona fide debt service fund or a reasonably required reserve or replacement fund;

(B) The net sale proceeds of the issue-

(1) Qualified for one of the temporary periods available for capital projects, restricted working capital expenditures, or pooled financings under paragraphs §1.148-2 (e)(2), (e)(3), or (e)(4), and those net sales proceeds were in fact allocated to expenditures prior to the expiration of the longest applicable temporary period; or

(2) were deposited in a refunding escrow and expended as originally expected;

(C) The issue does not refund a prior issue that, on any transfer date, has unspent proceeds allocable to it;

(D) None of the bonds are retired prior to the date on which those bonds are treated as retired in computing the yield on the issue; and

(E) No proceeds of the issue are invested in qualified student loans or qualified mortgage loans.

(ii) General rule. Except as otherwise provided below, amounts that would otherwise be gross proceeds allocable to an issue are allocated (and remain allocated) to the issue only to the extent that the value of the nonpurpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue. For this purpose, gross proceeds allocable to cash, tax-exempt bonds that would be nonpurpose investments (absent section 148(b)(3)(A)), qualified student loans, and qualified mortgage loans are treated as nonpurpose investments. The values of bonds and investments are determined under §1.148-4(e) and §1.148-5(d), respectively. The value of all outstanding bonds of the issue is referred to as the universal cap. Thus, for example, the universal cap for an issue of plain par bonds is equal to the outstanding stated principal amount of those bonds plus accrued interest.

(iii) Determination and application of the universal cap. Except as otherwise provided, beginning with the first bond year that commences after the second anniversary of the issue date, the amount of the universal cap and the value of the nonpurpose investments must be determined as of the first day of each bond year. For refunding and refunded issues, the cap and values must be determined as of each date that, but for this paragraph (b)(2), proceeds of the refunded issue would become transferred proceeds of the refunding issue, and need not otherwise be determined in the bond year in which that date occurs. All values are determined as of the close of business on each determination date, after giving effect to all payments on bonds and payments for and receipts on investments on that date.

(iv) General ordering rule for allocations of amounts in excess of the universal cap- (A) In general. If the value of all nonpurpose investments allocated to the gross proceeds of an issue exceeds the universal cap for that issue on a date as of which the cap is determined under paragraph (b)(2)(iii) of this section, nonpurpose investments allocable to gross proceeds necessary to eliminate that excess cease to be allocated to the issue, in the following order of priority-

(1) First, nonpurpose investments allocable to replacement proceeds;

(2) Second, nonpurpose investments allocable to transferred proceeds; and

(3) Third, nonpurpose investments allocable to sale proceeds and investment proceeds.

(B) Re-allocation of certain amounts. Except as provided in §1.148-9(b)(3), amounts that cease to be allocated to an issue as a result of the application of the universal cap may only be allocated to another issue as replacement proceeds.

(C) Allocations of portions of investments. Portions of investments to which this paragraph (b)(2)(iv) applies are allocated under either the ratable method or the representative method in the same manner as allocations of portions of investments to transferred proceeds under §1.148-9(c).

(v) Nonpurpose investments in a bona fide debt service fund not counted. For purposes of this paragraph (b)(2), nonpurpose investments allocated to gross proceeds in a bona fide debt service fund for an issue are not taken into account in determining the value of the nonpurpose investments, and those nonpurpose investments remain allocated to the issue.

(c) Fair market value limit on allocations to nonpurpose investments. Upon a purchase or sale of a nonpurpose investment, gross proceeds of an issue are not allocated to a payment for that nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of the nonpurpose investment as of the purchase or sale date. For purposes of this paragraph (c) only, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to the investment.

(d) Allocation of gross proceeds to expenditures-(1) Expenditures in general-(i) General rule. Reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.

(ii) General limitation. An allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue. A current outlay of cash means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made.

(2) Treatment of gross proceeds invested in purpose investments-(i) In general. Gross proceeds of an issue invested in a purpose investment are allocated to an expenditure on the date on which the conduit borrower under the purpose investment allocates the gross proceeds to an expenditure in accordance with this paragraph (d).

(ii) Exception for qualified mortgage loans and qualified student loans. If gross proceeds of an issue are allocated to a purpose investment that is a qualified mortgage loan or a qualified student loan, those gross proceeds are allocated to an expenditure for the governmental purpose of the issue on the date on which the issuer allocates gross proceeds to that purpose investment.

(iii) Continuing allocation of gross proceeds to purpose investments. Regardless of whether gross proceeds of a conduit financing issue invested in a purpose investment have been allocated to an expenditure under paragraph (d)(2) (i) or (ii) of this section, with respect to the actual issuer those gross proceeds continue to be allocated to the purpose investment until the sale, discharge, or other disposition of the purpose investment.

(3) Expenditures for working capital purposes-(i) In general. Except as otherwise provided in this paragraph (d)(3) or paragraph (d)(4) of this section, proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts (as defined in paragraph (d)(3)(iii) of this section) as of that date (i.e., a "proceeds-spent-last" method). For this purpose, proceeds include replacement proceeds described in §1.148-1(c)(4).

(ii) Exceptions-(A) General de minimis exception. Paragraph (d)(3)(i) of this section does not apply to expenditures to pay-

(1) Any qualified administrative costs within the meaning of §§1.148-5(e)(2) (i) or (ii), or §1.148-5(e)(3)(ii)(A);

(2) Fees for qualified guarantees of the issue or payments for a qualified hedge for the issue;

(3) Interest on the issue for a period commencing on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service;

(4) Amounts paid to the United States under sections 1.148-3, 1.148-5(c), or 1.148-7 for the issue;

(5) Costs, other than those described in paragraphs (d)(3)(ii)(A) (1) through (4) of this section, that do not exceed 5 percent of the sale proceeds of an issue and that are directly related to capital expenditures financed by the issue (e.g., initial operating expenses for a new capital project);

(6) Principal or interest on an issue paid from unexpected excess sale or investment proceeds; and

(7) Principal or interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

(B) Exception for extraordinary items. Paragraph (d)(3)(i) of this section does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. If, however, an issuer or a related party maintains a reserve for such items (e.g., a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

(C) Exception for payment of principal and interest on prior issues. Paragraph (d)(3)(i) of this section does not apply to expenditures for payment of principal, interest, or redemption prices on a prior issue and, for a crossover refunding issue, interest on that issue.

(D) No exceptions if replacement proceeds created. The exceptions provided in this paragraph (d)(3)(ii) do not apply if the allocation merely substitutes gross proceeds for other amounts that would have been used to make those expenditures in a manner that gives rise to replacement proceeds. For example, if a purported reimbursement allocation of proceeds of a reimbursement bond does not result in an expenditure under §1.150-2, those proceeds may not be allocated to pay interest on an issue that, absent this allocation, would have been paid from the issuer's current revenues.

(iii) Definition of available amount-(A) In general. For purposes of this paragraph (d)(3), available amount means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of the issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

(B) Reasonable working capital reserve treated as unavailable. A reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amounts is made. For this purpose only, in determining the working capital expenditures of an issuer for a prior fiscal year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

(C) Qualified endowment funds treated as unavailable. For a 501(c)(3) organization that is a hospital, university, or similar institution, a qualified endowment fund is treated as unavailable. A fund is a qualified endowment fund if-

(1) The fund is derived from gifts or bequests, or the income thereon, that were neither made nor reasonably expected to be used to pay working capital expenditures;

(2) Pursuant to reasonable, established practices of the organization, the governing body of the 501(c)(3) organization designates and consistently operates the fund as a permanent endowment fund or quasi-endowment fund restricted as to use; and

(3) There is an independent verification (e.g., from an independent certified public accountant) that the fund is reasonably necessary as part of the organization's permanent capital.

(D) Application to statutory safe harbor for tax and revenue anticipation bonds. For purposes of section 148(f)(4)(B)(iii)(II), available amount has the same meaning as in paragraph (d)(3)(iii) of this section, except that the otherwise-permitted reasonable working capital reserve is treated as part of the available amount.

(4) Expenditures for grants-(i) In general. Gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made.

(ii) Characterization of repayments of grants. If any amount of a grant financed by gross proceeds of an issue is repaid to the grantor, the repaid amount is treated as unspent proceeds of the issue as of the repayment date unless expended within 60 days of repayment.

(iii) Definition of grant. Grant means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.

(5) Expenditures for reimbursement purposes. In allocating gross proceeds of issues of reimbursement bonds (as defined in §1.150-2)) to certain expenditures, §1.150-2 applies. In allocating gross proceeds to an expenditure to reimburse a previously paid working capital expenditure, paragraph (d)(3) of this section applies. Thus, if the expenditure is described in paragraph (d)(3)(ii) of this section or there are no available amounts on the date a working capital expenditure is made and there are no other available amounts on the date of the reimbursement of that expenditure, gross proceeds are allocated to the working capital expenditure as of the date of the reimbursement.

(6) Expenditures of certain commingled investment proceeds of governmental issues. This paragraph (d)(6) applies to any issue of governmental bonds, any issue of private activity bonds issued to finance a facility that is required by section 142 to be owned by a governmental unit, and any portion of an issue that is not treated as consisting of private activity bonds under section 141(b)(9). Investment proceeds of the issue (other than investment proceeds held in a refunding escrow) are treated as allocated to expenditures for a governmental purpose when the amounts are deposited in a commingled fund with substantial tax or other revenues from governmental operations of the issuer and the amounts are reasonably expected to be spent for governmental purposes within 6 months from the date of the commingling. In establishing these reasonable expectations, an issuer may use any reasonable accounting assumption and is not bound by the proceeds-spent-last assumption generally required for working capital expenditures under paragraph (d)(3) of this section.

(7) Payments to related parties. Any payment of gross proceeds of the issue to a related party of the payor is not an expenditure of those gross proceeds.

(e) Special rules for commingled funds-(1) In general. An accounting method for gross proceeds of an issue in a commingled fund, other than a bona fide debt service fund, is reasonable only if it satisfies the requirements of paragraphs (e)(2) through (6) of this section in addition to the other requirements of this section.

(2) Investments held by a commingled fund-(i) Required ratable allocations. Not less frequently than as of the close of each fiscal period, all payments and receipts (including deemed payments and receipts) on investments held by a commingled fund must be allocated (but not necessarily distributed) among the different investors in the fund. This allocation must be based on a consistently applied, reasonable ratable allocation method.

(ii) Safe harbors for ratable allocation methods. Reasonable ratable allocation methods include, without limitation, methods that allocate these items in proportion to either-

(A) The average daily balances of the amounts in the commingled fund from different investors during a fiscal period (as described in paragraph (e)(4) of this section); or

(B) The average of the beginning and ending balances of the amounts in the commingled fund from different investors for a fiscal period that does not exceed one month.

(iii) Definition of investor. For purposes of this paragraph (e), the term investor means each different source of funds invested in a commingled fund. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, it is treated as two different investors.

(3) Certain expenditures involving a commingled fund. If a ratable allocation method is used under paragraph (d) of this section to allocate expenditures from the commingled fund, the same ratable allocation method must be used to allocate payments and receipts on investments in the commingled fund under paragraph (e)(2) of this section.

(4) Fiscal periods. The fiscal year of a commingled fund is the calendar year unless the fund adopts another fiscal year. A commingled fund may use any consistent fiscal period that does not exceed three months (e.g., a daily, weekly, monthly, or quarterly fiscal period).

(5) Unrealized gains and losses on investments of a commingled fund-(i) Mark-to-market requirement for internal commingled funds with longer-term investment portfolios. Except as otherwise provided in this paragraph (e), in the case of a commingled fund in which the issuer and any related party own more than 25 percent of the beneficial interests in the fund (an internal commingled fund), the fund must treat all its investments as if sold at fair market value either on the last day of the fiscal year or the last day of each fiscal period. The net gains or losses from these deemed sales of investments must be allocated to all investors of the commingled fund during the period since the last allocation.

(ii) Exception for internal commingled funds with shorter-term investment portfolios. If the remaining weighted average maturity of all investments held by a commingled fund during a particular fiscal year does not exceed 18 months, and the investments held by the commingled fund during that fiscal year consist exclusively of obligations, the mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply.

(iii) Exception for commingled reserve funds and sinking funds. The mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply to a commingled fund that operates exclusively as a reserve fund, sinking fund, or replacement fund for two or more issues of the same issuer.

(6) Allocations of commingled funds serving as common reserve funds or sinking funds-(i) Permitted ratable allocation methods. If a commingled fund serves as a common reserve fund, replacement fund, or sinking fund for two or more issues (a commingled reserve), after making reasonable adjustments to account for proceeds allocated under paragraph (b)(1) or (b)(2) of this section, investments held by that commingled fund must be allocated ratably among the issues served by the commingled fund in accordance with one of the following methods-

(A) The relative values of the bonds of those issues under §1.148-4(e);

(B) The relative amounts of the remaining maximum annual debt service requirements on the outstanding principal amounts of those issues; or

(C) The relative original stated principal amounts of the outstanding issues.

(ii) Frequency of allocations. An issuer must make any allocations required by this paragraph (e)(6) as of a date at least every 3 years and as of each date that an issue first becomes secured by the commingled reserve. If relative original principal amounts are used to allocate, allocations must also be made on the retirement of any issue secured by the commingled reserve.

§1.148-7 Spending exceptions to the rebate requirement.

(a) Scope of section-(1) In general. This section provides guidance on the spending exceptions to the arbitrage rebate requirement of section 148(f)(2). These exceptions are the 6-month exception in section 148(f)(4)(B) (the 6-month exception), the 18-month exception under paragraph (d) of this section (the 18-month exception), and the 2-year construction exception under section 148(f)(4)(C) (the 2-year exception) (collectively, the spending exceptions).

(2) Relationship of spending exceptions. Each of the spending exceptions is an independent exception to arbitrage rebate. For example, a construction issue may qualify for the 6-month exception or the 18-month exception even though the issuer makes one or more elections under the 2-year exception with respect to the issue.

(3) Spending exceptions not mandatory. Use of the spending exceptions is not mandatory. An issuer may apply the arbitrage rebate requirement to an issue that otherwise satisfies a spending exception. If an issuer elects to pay penalty in lieu of rebate under the 2-year exception, however, the issuer must apply those penalty provisions.

(b) Rules applicable for all spending exceptions. The provisions of this paragraph (b) apply for purposes of applying each of the spending exceptions.

(1) Special transferred proceeds rules-(i) Application to prior issues. For purposes of applying the spending exceptions to a prior issue only, proceeds of the prior issue

that become transferred proceeds of the refunding issue continue to be treated as unspent proceeds of the prior issue. If the prior issue satisfies one of the spending exceptions, the proceeds of the prior issue that are excepted from rebate under that spending exception are not subject to rebate either as proceeds of the prior issue or as transferred proceeds of the refunding issue.

(ii) Application to refunding issues-(A) In general. The only spending exception applicable to refunding issues is the 6-month exception. For purposes of applying the 6-month exception to a refunding issue only, proceeds of the prior issue that become transferred proceeds of the refunding issue generally are not treated as proceeds of the refunding issue and need not be spent for the refunding issue to satisfy that spending exception. Even if the refunding issue qualifies for that spending exception, those transferred proceeds are subject to rebate as proceeds of the refunding issue unless an exception to rebate applied to those proceeds as proceeds of the prior issue.

(B) Exception. For purposes of applying the 6-month exception to refunding issues, those transferred proceeds of the refunding issue excluded from the gross proceeds of the prior issue under the special definition of gross proceeds in paragraph (c)(3) of this section, and those that transferred from a prior taxable issue, are generally treated as gross proceeds of the refunding issue. Thus, for the refunding issue to qualify for the 6-month exception, those proceeds must be spent within 6 months of the issue date of the refunding issue, unless those amounts continue to be used in a manner that does not cause those amounts to be gross proceeds under paragraph (c)(3) of this section.

(2) Application of multipurpose issue rules. Except as otherwise provided, if any portion of an issue is treated as a separate issue allocable to refunding purposes under §1.148-9(h) (relating to multipurpose issues), for purposes of this section, that portion is treated as a separate issue.

(3) Expenditures for governmental purposes of the issue. For purposes of this section, expenditures for the governmental purpose of an issue include payments for interest, but not principal, on the issue, and for principal or interest on another issue of obligations. The preceding sentence does not apply for purposes of the 18-month and 2-year exceptions if those payments cause the issue to be a refunding issue.

(4) De minimis rule. Any failure to satisfy the final spending requirement of the 18-month exception or the 2-year exception is disregarded if the issuer exercises due diligence to complete the project financed and the amount of the failure does not exceed the lesser of 3 percent of the issue price of the issue or $250,000.

(5) Special definition of reasonably required reserve or replacement fund. For purposes of this section only, a reasonably required reserve or replacement fund also includes any fund to the extent described in §1.148-5(c)(3)(i)(E) or (G).

(6) Pooled financing issue-(i) In general. Except as otherwise provided in this paragraph (b)(6), the spending exceptions apply to a pooled financing issue as a whole, rather than to each loan separately.

(ii) Election to apply spending exceptions separately to each loan-(A) In general. At the election (made on or before the issue date) of the issuer of a pooled financing issue, the spending exceptions are applied separately to each conduit loan, and the applicable spending requirements for a loan begin on the earlier of the date the loan is made, or the first day following the 1-year period beginning on the issue date of the pooled financing issue. If this election is made, the rebate requirement applies to, and none of the spending exceptions are available for, gross proceeds of the pooled financing bonds before the date on which the spending requirements for those proceeds begin.

(B) Application of spending exceptions. If the issuer makes the election under this paragraph (b)(6)(ii), the rebate requirement is satisfied for proceeds used to finance a particular conduit loan to the extent that the loan satisfies a spending exception or the small issuer exception under §1.148-8, regardless of whether any other conduit loans allocable to the issue satisfy such an exception. A pooled financing issue is an issue of arbitrage bonds, however, unless the entire issue satisfies the requirements of section 148. An issuer may pay rebate for some conduit loans and 11/2 percent penalty for other conduit loans from the same pooled financing issue. The 11/2 percent penalty is computed separately for each conduit loan.

(C) Elections under 2-year exception. If the issuer makes the election under this paragraph (b)(6)(ii), the issuer may make all elections under the 2-year exception separately for each loan. Elections regarding a loan that otherwise must be made by the issuer on or before the issue date instead may be made on or before the date the loan is made (but not later than 1 year after the issue date).

(D) Example. The operation of this paragraph (b)(6) is illustrated by the following example:

Example. Pooled financing issue. On January 1, 1994, Authority J issues bonds. As of the issue date, J reasonably expects to use the proceeds of the issue to make loans to City K, County L, and City M. J does not reasonably expect to use more than 75 percent of the available construction proceeds of the issue for construction expenditures. On or before the issue date, J elects to apply the spending exceptions separately for each loan, with spending requirements beginning on the earlier of the date the loan is made or the first day following the 1-year period beginning on the issue date. On February 1, 1994, J loans a portion of the proceeds to K, and K reasonably expects that 45 percent of those amounts will be used for construction expenditures. On the date this loan is made, J elects under paragraph (j) of this section to treat 60 percent of the amount loaned to K as a separate construction issue, and also elects the 11/2 percent penalty under paragraph (k) of this section for the separate construction issue. On March 1, 1994, J loans a portion of the proceeds to L, and L reasonably expects that more than 75 percent of those amounts will be used for construction expenditures. On March 1, 1995, J loans the remainder of the proceeds to M, and none of those amounts will be used for construction expenditures. J must satisfy the rebate requirement for all gross proceeds before those amounts are loaned. For the loan to K, the spending periods begin on February 1, 1994, and the 11/2 percent penalty must be paid for any failure to meet a spending requirement for the portion of the loan to K that is treated as a separate construction issue. Rebate must be paid on the remaining portion of the loan to K, unless that portion qualifies for the 6-month exception. For the loan to L, the spending periods begin on March 1, 1994, and the rebate requirement must be satisfied unless the 6-month, 18-month, or the 2-year except ion is satisfied with respect to those amounts. For the loan to M, the spending periods begin on January

2, 1995, and the rebate requirement must be satisfied for those amounts unless the 6-month or 18-month exception is satisfied.

(c) 6-month exception- (1) General rule. An issue is treated as meeting the rebate requirement if-

(i) The gross proceeds (as modified by paragraph (c)(3) of this section) of the issue are allocated to expenditures for the governmental purposes of the issue within the 6-month period beginning on the issue date (the 6-month spending period); and

(ii) The rebate requirement is met for amounts not required to be spent within the 6-month spending period (excluding earnings on a bona fide debt service fund).

(2) Additional period for certain bonds. The 6-month spending period is extended for an additional 6 months in certain circumstances specified under section 148(f)(4)(B)(ii).

(3) Amounts not included in gross proceeds. For purposes of paragraph (c)(1)(i) of this section only, gross proceeds has the meaning used in §1.148-1, except it does not include amounts-

(i) In a bona fide debt service fund;

(ii) In a reasonably required reserve or replacement fund (see §1.148-7(b)(5));

(iii) That, as of the issue date, are not reasonably expected to be gross proceeds but that become gross proceeds after the end of the 6-month spending period;

(iv) Representing sale or investment proceeds derived from payments under any purpose investment of the issue; and

(v) Representing repayments of grants (as defined in §1.148-6(d)(4)) financed by the issue.

(4) Series of refundings. If a principal purpose of a series of refunding issues is to exploit the difference between taxable and tax-exempt interest rates by investing proceeds during the temporary periods provided in §1.148-9(d), the 6-month spending period for all issues in the series begins on the issue date of the first issue in the series.

(d) 18-month exception-(1) General rule. An issue is treated as meeting the rebate requirement if all of the following requirements are satisfied-

(i) 18-month expenditure schedule met. The gross proceeds (as defined in paragraph (d)(3) of this section) are allocated to expenditures for a governmental purpose of the issue in accordance with the following schedule (the 18-month expenditure schedule) measured from the issue date-

(A) At least 15 percent within 6 months (the first spending period);

(B) At least 60 percent within 12 months (the second spending period); and

(C) 100 percent within 18 months (the third spending period).

(ii) Rebate requirement met for amounts not required to be spent. The rebate requirement is met for all amounts not required to be spent in accordance with the 18-month expenditure schedule (other than earnings on a bona fide debt service fund).

(iii) Issue qualifies for initial temporary period. All of the gross proceeds (as defined in paragraph (d)(3)(i) of this section) of the issue qualify for the initial temporary period under §1.148-2(e)(2).

(2) Extension for reasonable retainage. An issue does not fail to satisfy the spending requirement for the third spending period as a result of a reasonable retainage if the reasonable retainage is allocated to expenditures within 30 months of the issue date. Reasonable retainage has the meaning under paragraph (h) of this section, as modified to refer to net sale proceeds on the date 18 months after the issue date.

(3) Gross proceeds-(i) Definition of gross proceeds. For purposes of paragraph (d)(1) of this section only, gross proceeds means gross proceeds as defined in paragraph (c)(3) of this section, as modified to refer to "18 months" in paragraph (c)(3)(iii) of this section in lieu of "6 months."

(ii) Estimated earnings. For purposes of determining compliance with the first two spending periods under paragraph (d)(1)(i) of this section, the amount of investment proceeds included in gross proceeds of the issue is determined based on the issuer's reasonable expectations on the issue date.

(4) Application to multipurpose issues. This paragraph (d) does not apply to an issue any portion of which is treated as meeting the rebate requirement under paragraph (e) of this section (relating to the 2-year exception).

(e) 2-year exception-(1) General rule. A construction issue is treated as meeting the rebate requirement for available construction proceeds if those proceeds are allocated to expenditures for governmental purposes of the issue in accordance with the following schedule (the 2-year expenditure schedule), measured from the issue date-

(i) At least 10 percent within 6 months (the first spending period);

(ii) At least 45 percent within 1 year (the second spending period);

(iii) At least 75 percent within 18 months (the third spending period); and

(iv) 100 percent within 2 years (the fourth spending period).

(2) Extension for reasonable retainage. An issue does not fail to satisfy the spending requirement for the fourth spending period as a result of unspent amounts for reasonable retainage (as defined in paragraph (h) of this section) if those amounts are allocated to expenditures within 3 years of the issue date.

(3) Definitions. For purposes of the 2-year exception, the following definitions apply:

(i) Real property means land and improvements to land, such as buildings or other inherently permanent structures, including interests in real property. For example, real property includes wiring in a building, plumbing systems, central heating or air-conditioning systems, pipes or ducts, elevators, escalators installed in a building, paved parking areas, roads, wharves and docks, bridges, and sewage lines.

(ii) Tangible personal property means any tangible property other than real property, including interests in tangible personal property. For example, tangible personal property includes machinery that is not a structural component of a building, subway cars, fire trucks, automobiles, office equipment, testing equipment, and furnishings.

(iii) Substantially completed. Construction may be treated as substantially completed when the issuer abandons construction or when at least 90 percent of the total costs of the construction reasonably expected, as of that date, to be financed with the available construction proceeds have been allocated to expenditures.

(f) Construction issue-(1) Definition. Construction issue means any issue that is not a refunding issue if-

(i) The issuer reasonably expects, as of the issue date, that at least 75 percent of the available construction proceeds of the issue will be allocated to construction expenditures (as defined in paragraph (g) of this section) for property owned by a governmental unit or a 501(c)(3) organization; and

(ii) Any private activity bonds that are part of the issue are qualified 501(c)(3) bonds or private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization.

(2) Use of actual facts. For the provisions of paragraphs (e) through (m) of this section that apply based on the issuer's reasonable expectations, an issuer may elect on or before the issue date to apply all of those provisions based on actual facts.

(3) Ownership requirement-(i) In general. A governmental unit or 501(c)(3) organization is treated as the owner of property if it would be treated as the owner for Federal income tax purposes. For obligations issued on behalf of a State or local governmental unit, the entity that actually issues the bonds is treated as a governmental unit.

(ii) Safe harbor for leases and management contracts. Property leased by a governmental unit or a 501(c)(3) organization is treated as owned by the governmental unit or 501(c)(3) organization if the lessee complies with the requirements of section 142(b)(1)(B). For a bond described in section 142(a)(6), the requirements of section 142(b)(1)(B) apply as modified by section 146(h)(2).

(g) Construction expenditures-(1) Definition. Except as otherwise provided, construction expenditures means capital expenditures (as defined in §1.150-1) that are allocable to the cost of real property or constructed personal property (as defined in paragraph (g)(3) of this section). Except as provided in paragraph (g)(2) of this section, construction expenditures do not include expenditures for acquisitions of interests in land or other existing real property.

(2) Certain acquisitions under turnkey contracts treated as construction expenditures. Expenditures are not for the acquisition of an interest in existing real property other than land if the contract between the seller and the issuer requires the seller to build or install the property (e.g., a turnkey contract), but only to the extent that the property has not been built or installed at the time the parties enter into the contract.

(3) Constructed personal property. Constructed personal property means tangible personal property (or, if acquired pursuant to a single acquisition contract, properties) or specially developed computer software if-

(i) A substantial portion of the property or properties is completed more than 6 months after the earlier of the date construction or rehabilitation commenced and the date the issuer entered into an acquisition contract;

(ii) Based on the reasonable expectations of the issuer, if any, or representations of the person constructing the property, with the exercise of due diligence, completion of construction or rehabilitation (and delivery to the issuer) could not have occurred within that 6-month period; and

(iii) If the issuer itself builds or rehabilitates the property, not more than 75 percent of the capitalizable cost is attributable to property acquired by the issuer (e.g., components, raw materials, and other supplies).

(4) Specially developed computer software. Specially developed computer software means any programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs, provided that the software is specially developed and is functionally related and subordinate to real property or other constructed personal property.

(5) Examples. The operation of this paragraph (g) is illustrated by the following examples:

Example 1. Purchase of construction materials. City A issues bonds to finance a new office building. A uses proceeds of the bonds to purchase materials to be used in constructing the building, such as bricks, pipes, wires, lighting, carpeting, heating equipment, and similar materials. Expenditures by A for the construction materials are construction expenditures because those expenditures will be capitalizable to the cost of the building upon completion, even though they are not initially capitalizable to the cost of existing real property. This result would be the same if A hires a third-party to perform the construction, unless the office building is partially constructed at the time that A contracts to purchase the building.

Example 2. Turnkey contract. City B issues bonds to finance a new office building. B enters into a turnkey contract with developer D under which D agrees to provide B with a completed building on a specified completion date on land currently owned by D. Under the agreement, D holds title to the land and building and assumes any risk of loss until the completion date, at which time title to the land and the building will be transferred to B. No construction has been performed by the date that B and D enter into the agreement. All payments by B to D for construction of the building are construction expenditures because all the payments are properly capitalized to the cost of the building, but payments by B to D allocable to the acquisition of the land are not construction expenditures.

Example 3. Right-of-way. P, a public agency, issues bonds to finance the acquisition of a right-of-way and the construction of sewage lines through numerous parcels of land. The right-of-way is acquired primarily through P's exercise of its powers of eminent domain. As of the issue date, P reasonably expects that it will take approximately 2 years to acquire the entire right-of-way because of the time normally required for condemnation proceedings. No expenditures for the acquisition of the right-of-way are construction expenditures because they are costs incurred to acquire an interest in existing real property.

Example 4. Subway cars. City C issues bonds to finance new subway cars. C reasonably expects that it will take more than 6 months for the subway cars to be constructed to C's specifications. The subway cars are constructed personal property. Alternatively, if the builder of the subway cars informs C that it will only take 3 months to build the subway cars to C's specifications, no payments for the subway cars are construction expenditures.

Example 5. Fractional interest in property. U, a public agency, issues bonds to finance an undivided fractional interest in a newly constructed power-generating facility. U contributes its ratable share of the cost of building the new facility to the project manager for the facility. U's contributions are construction expenditures in the same proportion that the total expenditures for the facility qualify as construction expenditures.

Example 6. Park land. City D issues bonds to finance the purchase of unimproved land and the cost of subsequent improvements to the land, such as grading and landscaping, necessary to transform it into a park. The costs of the improvements are properly capitalizable to the cost of the land, and therefore, are construction expenditures, but expenditures for the acquisition of the land are not.

(h) Reasonable retainage definition. Reasonable retainage means an amount, not to exceed 5 percent of available construction proceeds as of the end of the fourth spending period, that is retained for reasonable business purposes relating to the property financed with the proceeds of the issue. For example, a reasonable retainage may include a retention to ensure or promote compliance with a construction contract in circumstances in which the retained amount is not yet payable, or in which the issuer reasonably determines that a dispute exists regarding completion or payment.

(i) Available construction proceeds-(1) Definition in general. Available construction proceeds has the meaning used in section 148(f)(4)(C)(vi). For purposes of this definition, earnings include earnings on any tax-exempt bond. Pre-issuance accrued interest and earnings thereon may be disregarded. Amounts that are not gross proceeds as a result of the application of the universal cap under §1.148-6(b)(2) are not available construction proceeds.

(2) Earnings on a reasonably required reserve or replacement fund. Earnings on any reasonably required reserve or replacement fund are available construction proceeds only to the extent that those earnings accrue before the earlier of the date construction is substantially completed or the date that is 2 years after the issue

date. An issuer may elect on or before the issue date to exclude from available construction proceeds the earnings on such a fund. If the election is made, the rebate requirement applies to the excluded amounts from the issue date.

(3) Reasonable expectations test for future earnings. For purposes of determining compliance with the spending requirements as of the end of each of the first three spending periods, available construction proceeds include the amount of future earnings that the issuer reasonably expected as of the issue date.

(4) Issuance costs. Available construction proceeds do not include gross proceeds used to pay issuance costs financed by an issue, but do include earnings on such proceeds. Thus, an expenditure of gross proceeds of an issue for issuance costs does not count toward meeting the spending requirements. The expenditure of earnings on gross proceeds used to pay issuance costs does count toward meeting those requirements. If the spending requirements are met and the proceeds used to pay issuance costs are expended by the end of the fourth spending period, those proceeds and the earnings thereon are treated as having satisfied the rebate requirement.

(5) One and one-half percent penalty in lieu of arbitrage rebate. For purposes of the spending requirements of paragraph (e) of this section, available construction proceeds as of the end of any spending period are reduced by the amount of penalty in lieu of arbitrage rebate (under paragraph (k) of this section) that the issuer has paid from available construction proceeds before the last day of the spending period.

(6) Payments on purpose investments and repayments of grants. Available construction proceeds do not include-

(i) Sale or investment proceeds derived from payments under any purpose investment of the issue; or

(ii) Repayments of grants (as defined in §1.148-6(d)(4)) financed by the issue.

(7) Examples. The operation of this paragraph (i) is illustrated by the following examples:

Example 1. Treatment of investment earnings. City F issues bonds having an issue price of $10,000,000. F deposits all of the proceeds of the issue into a construction fund to be used for expenditures other than costs of issuance. F estimates on the issue date that, based on reasonably expected expenditures and rates of investment, earnings on the construction fund will be $800,000. As of the issue date and the end of each of the first three spending periods, the amount of available construction proceeds is $10,800,000. To qualify as a construction issue, F must reasonably expect on the issue date that at least $8,100,000 (75 percent of $10,800,000) will be used for construction expenditures. In order to meet the 10 percent spending requirement at the end of the first spending period, F must spend at least $1,080,000. As of the end of the fourth spending period, F has received $1,100,000 in earnings. In order to meet the spending requirement at the end of the fourth spending period, however, F must spend all of the $11,100,000 of actual available construction proceeds (except for reasonable retainage not exceeding $555,000).

Example 2. Treatment of investment earnings without a reserve fund. City G issues bonds having an issue price of $11,200,000. G does not elect to exclude earnings on the reserve fund from available construction proceeds. G uses $200,000 of proceeds to pay issuance costs and deposits $1,000,000 of proceeds into a reasonably required reserve fund. G deposits the remaining $10,000,000 of proceeds into a construction fund to be used for construction expenditures. On the issue date, G reasonably expects that, based on the reasonably expected date of substantial completion and rates of investment, total earnings on the construction fund will be $800,000, and total earnings on the reserve fund to the date of substantial completion will be $150,000. G reasonably expects that substantial completion will occur during the fourth spending period. As of the issue date, the amount of available construction proceeds is $10,950,000 ($10,000,000 originally deposited into the construction fund plus $800,000 expected earnings on the construction fund and $150,000 expected earnings on the reserve fund). To qualify as a construction issue, G must reasonably expect on the issue date that at least $8,212,500 will be used for construction expenditures.

Example 3. Election to exclude earnings on a reserve fund. The facts are the same as Example 2, except that G elects on the issue date to exclude earnings on the reserve fund from available construction proceeds. The amount of available construction proceeds as of the issue date is $10,800,000.

(j) Election to treat portion of issue used for construction as separate issue-(1) In general. For purposes of paragraph (e) of this section, if any proceeds of an issue are to be used for construction expenditures, the issuer may elect on or before the issue date to treat the portion of the issue that is not a refunding issue as two, and only two, separate issues, if-

(i) One of the separate issues is a construction issue as defined in paragraph (f) of this section;

(ii) The issuer reasonably expects, as of the issue date, that this construction issue will finance all of the construction expenditures to be financed by the issue; and

(iii) The issuer makes an election to apportion the issue under this paragraph (j)(1) in which it identifies the amount of the issue price of the issue allocable to the construction issue.

(2) Example. The operation of this paragraph (j) is illustrated by the following example.

Example. City D issues bonds having an issue price of $19,000,000. On the issue date, D reasonably expects to use $10,800,000 of bond proceeds (including investment earnings) for construction expenditures for the project being financed. D deposits $10,000,000 in a construction fund to be used for construction expenditures and $9,000,000 in an acquisition fund to be used for acquisition of equipment not qualifying as construction expenditures. D estimates on the issue date, based on reasonably expected expenditures and rates of investment, that total earnings on the construction fund will be $800,000 and total earnings on the acquisition fund will be $200,000. Because the total construction expenditures to be financed by the issue are expected to be $10,800,000, the maximum available construction proceeds for a construction issue is $14,400,000 ($10,800,000 divided by 0.75). To determine the maximum amount of the issue price allocable to a construction issue, the estimated investment earnings allocable to the construction issue are subtracted. The entire $800,000 of earnings on the construction fund are allocable to the construction issue. Only a portion of the $200,000 of earnings on the acquisition fund, however, are allocable to the construction issue. The total amount of the available construction proceeds that is expected to be used for acquisition is $3,600,000 ($14,400,000$10,800,000). The portion of earnings on the acquisition fund that is allocable to the construction issue is $78,261 ($200,000$3,600,000/$9,200,000). Accordingly, D may elect on or before the issue date to treat up to $13,521,739 of the issue price as a construction issue ($14,400,000$800,000$78,261). D's election must specify the amount of the issue price treated as a construction issue. The balance of the issue price is treated as a separate nonconstruction issue that is subject to the rebate requirement unless it meets another exception to arbitrage rebate. Because the financing of a construction issue is a separate governmental purpose under §1.148-9(h), the election causes the issue to be a multipurpose issue under that section.

(k) One and one-half percent penalty in lieu of arbitrage rebate-(1) In general. Under section 148(f)(4)(C)(vii), an issuer of a construction issue may elect on or before the issue date to pay a penalty (the 11/2 percent penalty) to the United States in lieu of the obligation to pay the rebate amount on available construction proceeds upon failure to satisfy the spending requirements of paragraph (e) of this section. The 11/2 percent penalty is calculated separately for each spending period, including each semiannual period after the end of the fourth spending period, and is equal to 1.5 percent times the underexpended proceeds as of the end of the spending period. For each spending period, underexpended proceeds equal the amount of available construction proceeds required to be spent by the end of the spending period, less the amount actually allocated to expenditures for the governmental purposes of the issue by that date. The 11/2 percent penalty must be paid to the United States no later than 90 days after the end of the spending period to which it relates. The 11/2 percent penalty continues to apply at the end of each spending period and each semiannual period thereafter until the earliest of the following-

(i) The termination of the penalty under paragraph ( ) of this section;

(ii) The expenditure of all of the available construction proceeds; or

(iii) The last stated final maturity date of bonds that are part of the issue and any bonds that refund those bonds.

(2) Application to reasonable retainage. If an issue meets the exception for reasonable retainage except that all retainage is not spent within 3 years of the issue date, the issuer must pay the 11/2 percent penalty to the United States for any reasonable retainage that was not so spent as of the close of the 3-year period and each later spending period.

(3) Coordination with rebate requirement. The rebate requirement is treated as met with respect to available construction proceeds for a period if the 11/2 percent penalty is paid in accordance with this section.

(l) Termination of 11/2 percent penalty-(1) Termination after initial temporary period. The issuer may terminate the 11/2 percent penalty after the initial temporary period (a section 148(f)(4)(C)(viii) penalty termination) if-

(i) Not later than 90 days after the earlier of the end of the initial temporary period or the date construction is substantially completed, the issuer elects to terminate the 11/2 percent penalty; provided that solely for this purpose, the initial temporary period may be extended by the issuer to a date ending 5 years after the issue date;

(ii) Within 90 days after the end of the initial temporary period, the issuer pays a penalty equal to 3 percent of the unexpended available construction proceeds determined as of the end of the initial temporary period, multiplied by the number of years (including fractions of years computed to 2 decimal places) in the initial temporary period;

(iii) For the period beginning as of the close of the initial temporary period, the unexpended available construction proceeds are not invested in higher yielding investments; and

(iv) On the earliest date on which the bonds may be called or otherwise redeemed, with or without a call premium, the unexpended available construction proceeds as of that date (not including any amount earned after the date on which notice of the redemption was required to be given) must be used to redeem the bonds. Amounts used to pay any call premium are treated as used to redeem bonds. This redemption requirement may be met by purchases of bonds by the issuer on the open market at prices not exceeding fair market value. A portion of the annual principal payment due on serial bonds of a construction issue may be paid from the unexpended amount, but only in an amount no greater than the amount that bears the same ratio to the annual principal due that the total unexpended amount bears to the issue price of the construction issue.

(2) Termination before end of initial temporary period. If the construction to be financed by the construction issue is substantially completed before the end of the initial temporary period, the issuer may elect to terminate the 11/2 percent penalty before the end of the initial temporary period (a section 148(f)(4)(C)(ix) penalty termination) if-

(i) Before the close of the initial temporary period and not later than 90 days after the date the construction is substantially completed, the issuer elects to terminate the 11/2 percent penalty;

(ii) The election identifies the amount of available construction proceeds that will not be spent for the governmental purposes of the issue; and

(iii) The issuer has met all of the conditions for a section 148(f)(4)(C)(viii) penalty termination, applied as if the initial temporary period ended as of the date the required election for a section 148(f)(4)(C)(ix) penalty termination is made. That penalty termination election satisfies the required election for a section 148(f)(4)(C)(viii) termination.

(3) Application to reasonable retainage. Solely for purposes of determining whether the conditions for terminating the 11/2 percent penalty are met, reasonable retainage may be treated as spent for a governmental purpose of the construction issue. Reasonable retainage that is so treated continues to be subject to the 11/2 percent penalty.

(4) Example. The operation of this paragraph (l) is illustrated by the following example.

Example. City I issues a construction issue having a 20-year maturity and qualifying for a 3-year initial temporary period. The bonds are first subject to optional redemption 10 years after the issue date at a premium of 3 percent. I elects, on or before the issue date, to pay the 11/2 percent penalty in lieu of arbitrage rebate. At the end of the 3-year temporary period, the project is not substantially completed, and $1,500,000 of available construction proceeds of the issue are unspent. At that time, I reasonably expects to need $500,000 to complete the project. I may terminate the 11/2 percent penalty in lieu of arbitrage rebate with respect to the excess $1,500,000 by electing to terminate within 90 days of the end of the initial temporary period; paying a penalty to the United States of $135,000 (3 percent of $1,500,000 multiplied by 3 years); restricting the yield on the investment of unspent available construction proceeds for 7 years until the first call date, although any portion of these proceeds may still be spent on the project prior to that call date; and using the available construction proceeds that, as of the first call date, have not been allocated to expenditures for the governmental purposes of the issue to redeem bonds on that call date. If I fails to make the termination election, I is required to pay the 11/2 percent penalty on unspent available construction proceeds every 6 months until the latest maturity date of bonds of the issue (or any bonds of another issue that refund such bonds).

(m) Payment of penalties. Each penalty payment under this section must be paid in the manner provided in §1.148-3(g). See §1.148-3(h) for rules on failures to pay penalties under this section.

§1.148-8 Small issuer exception to rebate requirement.

(a) Scope. Under section 148(f)(4)(D), bonds issued to finance governmental activities of certain small issuers are treated as meeting the arbitrage rebate requirement of section 148(f)(2) (the "small issuer exception"). This section provides guidance on the small issuer exception.

(b) General taxing powers. The small issuer exception generally applies only to bonds issued by governmental units with general taxing powers. A governmental unit has general taxing powers if it has the power to impose taxes (or to cause another entity to impose taxes) of general applicability which, when collected, may be used for the general purposes of the issuer. The taxing power may be limited to a specific type of tax, provided that the applicability of the tax is not limited to a small number of persons. The governmental unit's exercise of its taxing power may be subject to procedural limitations, such as voter approval requirements, but may not be contingent on approval by another governmental unit. See, also, section 148(f)(4)(D)(iv).

(c) Size limitation-(1) In general. An issue (other than a refunding issue) qualifies for the small issuer exception only if the issuer reasonably expects, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it during that calendar year will not exceed $5,000,000; or the aggregate face amount of all tax-exempt bonds of the issuer (other than private activity bonds) actually issued during that calendar year does not exceed $5,000,000. For this purpose, if an issue has more than a de minimis amount of original issue discount or premium, aggregate face amount means the aggregate issue price of that issue (determined without regard to pre-issuance accrued interest).

(2) Aggregation rules. The following aggregation rules apply for purposes of applying the $5,000,000 size limitation under paragraph (c)(1) of this section.

(i) On-behalf-of issuers. An issuer and all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.

(ii) Subordinate entities-(A) In general. Except as otherwise provided in paragraph (d) of this section and section 148(f)(4)(D)(iv), all bonds issued by a subordinate entity are also treated as issued by each entity to which it is subordinate. An issuer is subordinate to another governmental entity if it is directly or indirectly controlled by the other entity within the meaning of §1.150-1(e).

(B) Exception for allocations of size limitation. If an entity properly makes an allocation of a portion of its $5,000,000 size limitation to a subordinate entity (including an on behalf of issuer) under section 148(f)(4)(D)(iv), the portion of bonds issued by the subordinate entity under the allocation is treated as issued only by the allocating entity and not by any other entity to which the issuing entity is subordinate. These allocations are irrevocable and must bear a reasonable relationship to the benefits received by the allocating unit from issues issued by the subordinate entity. The benefits to be considered include the manner in which-

(1) Proceeds are to be distributed;

(2) The debt service is to be paid;

(3) The facility financed is to be owned;

(4) The use or output of the facility is to be shared; and

(5) Costs of operation and maintenance are to be shared.

(iii) Avoidance of size limitation. An entity formed or availed of to avoid the purposes of the $5,000,000 size limitation and all entities that would benefit from the avoidance are treated as one issuer. Situations in which an entity is formed or availed of to avoid the purposes of the $5,000,000 size limitation include those in which the issuer-

(A) Issues bonds which, but for the $5,000,000 size limitation, would have been issued by another entity; and

(B) Does not receive a substantial benefit from the project financed by the bonds.

(3) Certain refunding bonds not taken into account. In applying the $5,000,000 size limitation, there is not taken into account the portion of an issue that is a current refunding issue to the extent that the stated principal amount of the refunding bond does not exceed the portion of the outstanding stated principal amount of the refunded bond paid with proceeds of the refunding bond. For this purpose, principal amount means, in reference to a plain par bond, its stated principal amount plus accrued unpaid interest, and in reference to any other bond, its present value.

(d) Pooled financings-(1) Treatment of pool issuer. To the extent that an issuer of a pooled financing is not an ultimate borrower in the financing and the conduit borrowers are governmental units with general taxing powers and not subordinate to the issuer, the pooled financing is not counted towards the $5,000,000 size limitation of the issuer for purposes of applying the small issuer exception to its other issues. The issuer of the pooled financing issue is, however, subject to the rebate requirement for any unloaned gross proceeds.

(2) Treatment of conduit borrowers. A loan to a conduit borrower in a pooled financing qualifies for the small issuer exception, regardless of the size of either the pooled financing or of any loan to other conduit borrowers, only if-

(i) The bonds of the pooled financing are not private activity bonds;

(ii) None of the loans to conduit borrowers are private activity bonds; and

(iii) The loan to the conduit borrower meets all the requirements of the small issuer exception.

(e) Refunding issues-(1) In general. Sections 148(f)(4)(D) (v) and (vi) provide restrictions on application of the small issuer exception to refunding issues.

(2) Multipurpose issues. The multipurpose issue allocation rules of §1.148-9(h) apply for purposes of determining whether refunding bonds meet the requirements of section 148(f)(4)(D)(v).

§1.148-9 Arbitrage rules for refunding issues.

(a) Scope of application. This section contains special arbitrage rules for refunding issues. These rules apply for all purposes of section 148 and govern allocations of proceeds, bonds, and investments to determine transferred proceeds, temporary periods, reasonably required reserve or replacement funds, minor portions, and separate issue treatment of certain multipurpose issues.

(b) Transferred proceeds allocation rule-(1) In general. When proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue. The amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is an amount equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction-

(i) The numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge; and

(ii) The denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of that discharge.

(2) Special definition of principal amount. For purposes of this section, principal amount means, in reference to a plain par bond, its stated principal amount, and in reference to any other bond, its present value.

(3) Relation of transferred proceeds rule to universal cap rule-(i) In general. Paragraphs (b)(1) and (c) of this section apply to allocate transferred proceeds and corresponding investments to a refunding issue on any date required by those paragraphs before the application of the universal cap rule of §1.148-6(b)(2) to reallocate any of those amounts. To the extent nonpurpose investments allocable to proceeds of a refunding issue exceed the universal cap for the issue on the date that amounts become transferred proceeds of the refunding issue, those transferred proceeds and corresponding investments are reallocated back to the issue from which they transferred on that same date to the extent of the unused universal cap on that prior issue.

(ii) Example. The following example illustrates the application of this paragraph of (b)(3):

Example. On January 1, 1995, $100,000 of nonpurpose investments allocable to proceeds of issue A become transferred proceeds of issue B under §1.148-9, but the unused portion of issue B's universal cap is $75,000 as of that date. On January 1, 1995, issue A has unused universal cap in excess of $25,000. Thus, $25,000 of nonpurpose investments representing the transferred proceeds are immediately reallocated back to issue A on January 1, 1995, and are proceeds of issue A. On the next transfer date under §1.148-9, the $25,000 receives no priority in determining transferred proceeds as of that date but is treated the same as all other proceeds of issue A subject to transfer.

(4) Limitation on multi-generational transfers. This paragraph (b)(4) contains limitations on the manner in which proceeds of a first generation issue that is refunded by a refunding issue (a second generation issue) become transferred proceeds of a refunding issue (a third generation issue) that refunds the second generation issue. Proceeds of the first generation issue that become transferred proceeds of the third generation issue are treated as having a yield equal to the yield on the refunding escrow allocated to the second generation issue (i.e., as determined under §1.148-5(b)(2)(iv)). The determination of the transferred proceeds of the third generation issue does not affect compliance with the requirements of section 148, including the determination of the amount of arbitrage rebate with respect to or the yield on the refunding escrow, of the second generation issue.

(c) Special allocation rules for refunding issues-(1) Allocations of investments-(i) In general. Except as otherwise provided in this paragraph (c), investments purchased with sale proceeds or investment proceeds of a refunding issue must be allocated to those proceeds, and investments not purchased with those proceeds may not be allocated to those proceeds (i.e., a specific tracing method).

(ii) Allocations to transferred proceeds. When proceeds of a prior issue become transferred proceeds of a refunding issue, investments (and the related payments and receipts) of proceeds of the prior issue that are held in a refunding escrow for another issue are allocated to the transferred proceeds under the ratable allocation method described in paragraph (c)(1)(iii) of this section. Investments of proceeds of the prior issue that are not held in a refunding escrow for another issue are allocated to the transferred proceeds by application of the allocation methods described in paragraph (c)(1) (iii) or (iv) of this section, consistently applied to all investments on a transfer date.

(iii) Ratable allocation method. Under the ratable allocation method, a ratable portion of each nonpurpose and purpose investment of proceeds of the prior issue is allocated to transferred proceeds of the refunding issue.

(iv) Representative allocation method-(A) In general. Under the representative allocation method, representative portions of the portfolio of nonpurpose investments and the portfolio of purpose investments of proceeds of the prior issue are allocated to transferred proceeds of the refunding issue. Unlike the ratable allocation method, this representative allocation method permits an allocation of particular whole investments. Whether a portion is representative is based on all the facts and circumstances, including, without limitation, whether the current yields, maturities, and current unrealized gains or losses on the particular allocated investments are reasonably comparable to those of the unallocated investments in the aggregate. In addition, if a portion of nonpurpose investments is otherwise representative, it is within the issuer's discretion to allocate the portion from whichever source of funds it deems appropriate, such as a reserve fund or a construction fund for a prior issue.

(B) Mark-to-market safe harbor for representative allocation method. In addition to other representative allocations, a specific allocation of a particular nonpurpose investment to transferred proceeds (e.g., of lower yielding investments) is treated as satisfying the representative allocation method if that investment is valued at fair market value on the transfer date in determining the payments and receipts on that date, but only if the portion of the nonpurpose investments that transfers is based on the relative fair market value of all nonpurpose investments.

(2) Allocations of mixed escrows to expenditures for principal, interest, and redemption prices on a prior issue-(i) In general. Except for amounts required or permitted to be accounted for under paragraph (c)(2)(ii) of this section, proceeds of a refunding issue and other amounts that are not proceeds of a refunding issue that are deposited in a refunding escrow (a mixed escrow) must be accounted for under this paragraph (c)(2)(i). Those proceeds and other amounts must be allocated to expenditures for principal, interest, or stated redemption prices on the prior issue so that the expenditures of those proceeds do not occur faster than ratably with expenditures of the other amounts in the mixed escrow. If, however, the prior issue has unspent proceeds, these allocations must be ratable both between sources for expenditures (i.e., proceeds and other amounts) and between uses (i.e., principal, interest, and stated redemption prices on the prior issue).

(ii) Exceptions-(A) Mandatory allocation of certain non-proceeds to earliest expenditures. If amounts other than proceeds of the refunding issue are deposited in a mixed escrow, but before the issue date of the refunding issue those amounts had been held in a bona fide debt service fund or a fund to carry out the governmental purpose of the prior issue (e.g., a construction fund), those amounts must be allocated to the earliest expenditures from the mixed escrow.

(B) Permissive allocation of non-proceeds to earliest expenditures. Excluding amounts covered by paragraph (c)(2)(ii)(A) of this section and subject to any required earlier expenditure of those amounts, any amounts in a mixed escrow that are not proceeds of a refunding issue may be allocated to the earliest expenditures from the mixed escrow, provided that those expenditures occur before the date of any expenditure from the mixed escrow to pay any principal of the prior issue.

(d) Temporary periods in refundings-(1) In general. Proceeds of a refunding issue may be invested in higher yielding investments under section 148(c) only during the temporary periods described in paragraph (d)(2) of this section.

(2) Types of temporary periods in refundings. The available temporary periods for proceeds of a refunding issue are as follows:

(i) General temporary period for refunding issues. Except as otherwise provided in this paragraph (d)(2), the temporary period for proceeds (other than transferred proceeds) of a refunding issue is the period ending 30 days after the issue date of the refunding issue.

(ii) Temporary periods for current refunding issues-(A) In general. Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days.

(B) Temporary period for short-term current refunding issues. The temporary period for proceeds (other than transferred proceeds) of a current refunding issue that has an original term to maturity of 270 days or less may not exceed 30 days. The aggregate temporary periods for proceeds (other than transferred proceeds) of all current refunding issues described in the preceding sentence that are part of the same series of refundings is 90 days. An issue is part of a series of refundings if it finances or refinances the same expenditures for a particular governmental purpose as another issue.

(iii) Temporary periods for transferred proceeds-(A) In general. Except as otherwise provided in paragraph (d)(2)(iii)(B) of this section, each available temporary period for transferred proceeds of a refunding issue begins on the date those amounts become transferred proceeds of the refunding issue and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue.

(B) Termination of initial temporary period for prior issue in an advance refunding. The initial temporary period under §1.148-2(e) (2) and (3) for the proceeds of a prior issue that is refunded by an advance refunding issue (including transferred proceeds) terminates on the issue date of the advance refunding issue.

(iv) Certain short-term gross proceeds. Except for proceeds of a refunding issue held in a refunding escrow, proceeds otherwise reasonably expected to be used to pay principal or interest on the prior issue, replacement proceeds not held in a bona fide debt service fund, and transferred proceeds, the temporary period for gross proceeds of a refunding issue is the 13-month period beginning on the date of receipt.

(e) Reasonably required reserve or replacement funds in refundings. In addition to the requirements of §1.148-2(f), beginning on the issue date of a refunding issue, a reserve or replacement fund for a refunding issue or a prior issue is a reasonably required reserve or replacement fund under section 148(d) that may be invested in higher yielding investments only if the aggregate amount invested in higher yielding investments under this paragraph (e) for both the refunding issue and the prior issue does not exceed the size limitations under §1.148-2 (f)(2) and (f)(3), measured by reference to the refunding issue only (regardless of whether proceeds of the prior issue have become transferred proceeds of the refunding issue).

(f) Minor portions in refundings. Beginning on the issue date of the refunding issue, gross proceeds not in excess of a minor portion of the refunding issue qualify for investment in higher yielding investments under section 148(e), and gross proceeds not in excess of a minor portion of the prior issue qualify for investment in higher yielding investments under either section 148(e) or section 149(d)(3)(A)(v), whichever is applicable. Minor portion is defined in §1.148-2(g).

(g) Certain waivers permitted. On or before the issue date, an issuer may waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve or replacement fund. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion.

(h) Multipurpose issue allocations-(1) Application of multipurpose issue allocation rules. The portion of the bonds of a multipurpose issue reasonably allocated to any separate purpose under this paragraph (h) is treated as a separate issue for all purposes of section 148 except the following-

(i) Arbitrage yield. Except to the extent that the proceeds of an issue are allocable to two or more conduit loans that are tax-exempt bonds, determining the yield on a multipurpose issue and the yield on investments for purposes of the arbitrage yield restrictions of section 148 and the arbitrage rebate requirement of section 148(f);

(ii) Rebate amount. Except as provided in paragraph (h)(1)(i) of this section, determining the rebate amount for a multipurpose issue, including subsidiary matters with respect to that determination, such as the computation date credit under §1.148-3(d)(1), the due date for payments, and the $100,000 bona fide debt service fund exception under section 148(f)(4)(A)(ii);

(iii) Minor portion. Determining the minor portion of an issue under section 148(e);

(iv) Reasonably required reserve or replacement fund. Determining the portion of an issue eligible for investment in higher yielding investments as part of a reasonably required reserve fund under section 148(d); and

(v) Effective date. Applying the provisions of §1.148-11(b) (relating to elective retroactive application of §§1.148-1 through 1.148-10 to certain issues).

(2) Rules on allocations of multipurpose issues-(i) In general. This paragraph (h) applies to allocations of multipurpose issues, including allocations involving the refunding purposes of the issue. Except as otherwise provided in this paragraph (h), proceeds, investments, and bonds of a multipurpose issue may be allocated among the various separate purposes of the issue using any reasonable, consistently applied allocation method. An allocation is not reasonable if it achieves more favorable results under section 148 or 149(d) than could be achieved with actual separate issues. An allocation under this paragraph (h) may be made at any time, but once made may not be changed.

(ii) Allocations involving certain common costs. A ratable allocation of common costs (as described in paragraph (h)(3)(ii) of this section) among the separate purposes of the multipurpose issue is generally reasonable. If another allocation method more accurately reflects the extent to which any separate purpose of a multipurpose issue enjoys the economic benefit or bears the economic burden of certain common costs, that allocation method may be used.

(3) Separate purposes of a multipurpose issue-(i) In general. Separate purposes of a multipurpose issue include refunding a separate prior issue, financing a separate purpose investment, financing a construction issue (as defined in §1.148-7(f)), and any clearly discrete governmental purpose reasonably expected to be financed by that issue. In general, all integrated or functionally related capital projects that qualify for the same initial temporary period under §1.148-2(e)(2) are treated as having a single governmental purpose. The separate purposes of a refunding issue include the separate purposes of the prior issue, if any. Separate purposes may be treated as a single purpose if the proceeds used to finance those purposes are eligible for the same initial temporary period under section 148(c). For example, the use of proceeds of a multipurpose issue to finance separate qualified mortgage loans may be treated as a single purpose.

(ii) Financing common costs. Common costs of a multipurpose issue are not separate purposes. Common costs include issuance costs, accrued interest, capitalized interest on the issue, a reserve or replacement fund, qualified guarantee fees, and similar costs properly allocable to the separate purposes of the issue.

(iii) Example. The following example illustrates the application of this paragraph (h)(3).

Example. On January 1, 1994, Housing Authority of State A issues a $10 million issue (the 1994 issue) at an interest rate of 10 percent to finance qualified mortgage loans for owner-occupied residences under section 143. During 1994, A originates $5 million in qualified mortgage loans at an interest rate of 10 percent. In 1995, the market interest rates for housing loans falls to 8 percent and A is unable to originate further loans from the 1994 issue. On January 1, 1996, A issues a $5 million issue (the 1996 issue) at an interest rate of 8 percent to refund partially the 1994 issue. Under paragraph (h) of this section, A treats the portion of the 1994 issue used to originate $5 million in loans as a separate issue comprised of that group of purpose investments. A allocates those purpose investments representing those loans to that separate unrefunded portion of the issue. In addition, A treats the unoriginated portion of the 1994 issue as a separate issue and allocates the nonpurpose investments representing the unoriginated proceeds of the 1994 issue to the refunded portion of the issue. Thus, when proceeds of the 1996 issue are used to pay principal on the refunded portion of the 1994 issue that is treated as a separate issue under paragraph (h) of this section, only the portion of the 1994 issue representing unoriginated loan funds invested in nonpurpose investments transfer to become transferred proceeds of the 1996 issue.

(4) Allocations of bonds of a multipurpose issue-(i) Reasonable allocation of bonds to portions of issue. After reasonable adjustment of the issue price of a multipurpose issue to account for common costs, the portion of the bonds of a multipurpose issue allocated to a separate purpose must have an issue price that bears the same ratio to the aggregate issue price of the multipurpose issue as the portion of the sale proceeds of the multipurpose issue used for that separate purpose bears to the aggregate sale proceeds of the multipurpose issue. For a refunding issue used to refund two or more prior issues, the portion of the sales proceeds allocated to the refunding of a separate prior issue is based on the present value of the refunded debt service on that prior issue, using the yield on investments in the refunding escrow allocable to the entire refunding issue as the discount rate.

(ii) Safe harbor for pro rata allocation method for bonds. The use of the relative amount of sales proceeds used for each separate purpose to ratably allocate each bond or a ratable number of substantially identical whole bonds is a reasonable method for allocating bonds of a multipurpose issue.

(iii) Safe harbor for allocations of bonds used to finance separate purpose investments. An allocation of a portion of the bonds of a multipurpose issue to a particular purpose investment is generally reasonable if that purpose investment has principal and interest payments that reasonably coincide in time and amount to principal and interest payments on the bonds allocated to that purpose investment.

(iv) Rounding of bond allocations to next whole bond denomination permitted. An allocation that rounds each resulting fractional bond up or down to the next integral multiple of a permitted denomination of bonds of that issue not in excess of $100,000 does not prevent the allocation from satisfying this paragraph (h)(4).

(v) Restrictions on allocations of bonds to refunding purposes. For each portion of a multipurpose issue that is used to refund a separate prior issue, a method of allocating bonds of that issue is reasonable under this paragraph (h) only if, in addition to the requirements of paragraphs (h)(1) and (h)(2) of this section, the portion of the bonds allocated to the refunding of that prior issue-

(A) Results from a pro rata allocation under paragraph (h)(4)(ii) of this section;

(B) Reflects aggregate principal and interest payable in each bond year that is less than, equal to, or proportionate to, the aggregate principal and interest payable on the prior issue in each bond year;

(C) Results from an allocation of all the bonds of the entire multipurpose issue in proportion to the remaining weighted average economic life of the capital projects financed or refinanced by the issue, determined in the same manner as under section 147(b); or

(D) Results from another reasonable allocation method, but only to the extent that the application of the allocation methods provided in this paragraph (h)(4)(v) is not permitted under state law restrictions applicable to the bonds, reasonable terms of bonds issued before, or subject to a master indenture that became effective prior to, July 1, 1993, or other similar restrictions or circumstances. This paragraph (h)(4)(v)(D) shall be strictly construed and is available only if it does not result in a greater burden on the market for tax-exempt bonds than would occur using one of the other allocation methods provided in this paragraph (h)(4)(v). (See also §1.148-11(c)(2).)

(5) Limitation on multi-generation allocations. This paragraph (h) does not apply to allocations of a multipurpose refunded issue unless that refunded issue is refunded directly by an issue to which this paragraph (h) applies. For example, if a 1994 issue refunds a 1984 multipurpose issue, which in turn refunded a 1980 multipurpose issue, this paragraph (h) applies to allocations of the 1984 issue for purposes of allocating the refunding purposes of the 1994 issue, but does not permit allocations of the 1980 issue.

(i) Operating rules for separation of prior issue into refunded and unrefunded portions-(1) In general. For purposes of paragraph (h)(3)(i) of this section, the separate purposes of a prior issue include the refunded and unrefunded portions of the prior issue. Thus, the refunded and unrefunded portions are treated as separate issues under paragraph (h)(1) of this section. Those separate issues must satisfy the requirements of paragraphs (h) and (i) of this section. The refunded portion of the bonds of a prior issue is based on a fraction the numerator of which is the principal amount of the prior issue to be paid with proceeds of the refunding issue and the denominator of which is the outstanding principal amount of the bonds of the prior issue, each determined as of the issue date of the refunding issue. (See also paragraph (b)(2) of this section.)

(2) Allocations of proceeds and investments in a partial refunding. As of the issue date of a partial refunding issue under this paragraph (i), unspent proceeds of the prior issue are allocated ratably between the refunded and unrefunded portions of the prior issue and the investments allocable to those unspent proceeds are allocated in the manner required for the allocation of investments to transferred proceeds under paragraph (c)(1)(ii) of this section.

(3) References to prior issue. If the refunded and unrefunded portions of a prior issue are treated as separate issues under this paragraph (i), then, except to the extent that the context clearly requires otherwise (e.g., references to the aggregate prior issue in the mixed escrow rule in paragraph (c)(2) of this section), all references in this section to a prior issue refer only to the refunded portion of that prior issue.

§1.148-10 Anti-abuse rules and authority of Commissioner.

(a) Abusive arbitrage device-(1) In general. Bonds of an issue are arbitrage bonds under section 148 if an abusive arbitrage device under paragraph (a)(2) of this section is used in connection with the issue. This paragraph (a) is to be applied and interpreted broadly to carry out the purposes of section 148, as further described in §1.148-0. Except as otherwise provided in paragraph (c) of this section, any action that is expressly permitted by section 148 or §§1.148-1 through 1.148-11 is not an abusive arbitrage device (e.g., investment in higher yielding investments during a permitted temporary period under section 148(c)).

(2) Abusive arbitrage device defined. Any action is an abusive arbitrage device if the action has the effect of-

(i) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and

(ii) Overburdening the tax-exempt bond market.

(3) Exploitation of tax-exempt interest rates. An action may exploit tax-exempt interest rates under paragraph (a)(2) of this section as a result of an investment of any portion of the gross proceeds of an issue over any period of time, notwithstanding that, in the aggregate, the gross proceeds of the issue are not invested in higher yielding investments over the term of the issue.

(4) Overburdening the tax-exempt market. An action overburdens the tax-exempt bond market under paragraph (a)(2)(ii) of this section if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under section 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under §1.148-2(e)(2), (e)(3), or (e)(4). One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under §1.148-1(c)(4)(i)(B). These factors may be outweighed by other factors, however, such as bona fide cost underruns or long-term financial distress.

(b) Consequences of overburdening the tax-exempt bond market-(1) In general. An issue that overburdens the tax-exempt bond market (within the meaning of paragraph (a)(4) of this section) is subject to the following special limitations-

(i) Special yield restriction. Investments are subject to the definition of materially higher yield under §1.148-2(d) that is equal to one-thousandth of 1 percent. In addition, each investment is treated as a separate class of investments under §1.148-5(b)(2)(ii), the yield on which may not be blended with that of other investments.

(ii) Certain regulatory provisions inapplicable. The provisions of §1.148-5(c) (relating to yield reduction payments) and §1.148-5(e) (2) and (3) (relating to recovery of qualified administrative costs) do not apply.

(iii) Restrictive expenditure rule. Proceeds are not allocated to expenditures unless the proceeds-spent-last rule under §1.148-6(d)(3)(i) is satisfied, applied by treating those proceeds as proceeds to be used for restricted working capital expenditures. For this purpose, available amount includes a reasonable working capital reserve as defined in §1.148-6(d)(3)(iii)(B).

(2) Application. The provisions of this paragraph (b) only apply to the portion of the issue that overburdens the market for tax-exempt bonds, except that, for an issue that is reasonably expected as of the issue date to overburden the market, these provisions apply to all of the gross proceeds of the issue.

(c) Anti-abuse rules on excess gross proceeds of advance refunding issues-(1) In general. Except as otherwise provided in this paragraph (c), an abusive arbitrage device is used and bonds of an advance refunding issue are arbitrage bonds if the issue has excess gross proceeds.

(2) Definition of excess gross proceeds. Excess gross proceeds means all gross proceeds of an advance refunding issue that exceed an amount equal to 1 percent of sale proceeds of the issue, other than gross proceeds allocable to-

(i) Payment of principal, interest, or call premium on the prior issue;

(ii) Payment of pre-issuance accrued interest on the refunding issue, and interest on the refunding issue that accrues for a period up to the completion date of any capital project for which the prior issue was issued, plus one year;

(iii) A reasonably required reserve or replacement fund for the refunding issue or investment proceeds of such a fund;

(iv) Payment of costs of issuance of the refunding issue;

(v) Payment of administrative costs allocable to repaying the prior issue, carrying and repaying the refunding issue, or investments of the refunding issue;

(vi) Transferred proceeds allocable to expenditures for the governmental purpose of the prior issue;

(vii) Interest on purpose investments;

(viii) Replacement proceeds in a sinking fund for the refunding issue; and

(ix) Qualified guarantee fees for the refunding issue or the prior issue.

(3) Special treatment of transferred proceeds. For purposes of this paragraph (c), all unspent proceeds of the prior issue as of the issue date of the refunding issue are treated as transferred proceeds of the advance refunding issue.

(4) Special rule for crossover refundings. An advance refunding issue is not an issue of arbitrage bonds under this paragraph (c) if all excess gross proceeds of the refunding issue are used to pay interest that accrues on the refunding issue before the prior issue is discharged, and no gross proceeds of any refunding issue are used to pay interest on the prior issue or to replace funds used directly or indirectly to pay such interest (other than transferred proceeds used to pay interest on the prior issue that accrues for a period up to the completion date of the project for which the prior issue was issued, plus one year, or proceeds used to pay principal that is attributable to accrued original issue discount).

(5) Special rule for gross refundings. This paragraph (c)(5) applies if an advance refunding issue (the series B issue) is used together with one or more other advance refunding issues (the series A issues) in a gross refunding of a prior issue, but only if the use of a gross refunding method is required under bond documents that were effective prior to November 6, 1992. These advance refunding issues are not arbitrage bonds under this paragraph (c) if-

(i) All excess gross proceeds of the series B issue and each series A issue are investment proceeds used to pay principal and interest on the series B issue;

(ii) At least 99 percent of all principal and interest on the series B issue is paid with proceeds of the series B and series A issues or with the earnings on other amounts in the refunding escrow for the prior issue;

(iii) The series B issue is discharged not later than the prior issue; and

(iv) As of any date, the amount of gross proceeds of the series B issue allocated to expenditures does not exceed the aggregate amount of expenditures before that date for principal and interest on the series B issue, and administrative costs of carrying and repaying the series B issue, or of investments of the series B issue.

(d) Examples. The provisions of this section are illustrated by the following examples:

Example 1. Mortgage sale. In 1982, City issued its revenue issue (the 1982 issue) and lent the proceeds to Developer to finance a low-income housing project under former section 103(b)(4)(A) of the 1954 Code. In 1994, Developer encounters financial difficulties and negotiates with City to refund the 1982 issue. City issues $10 million in principal amount of its 8 percent bonds (the 1994 issue). City lends the proceeds of the 1994 issue to Developer. To evidence Developer's obligation to repay that loan, Developer, as obligor, issues a note to City (the City note). Bank agrees to provide Developer with a direct-pay letter of credit pursuant to which Bank will make all payments to the trustee for the 1994 issue necessary to meet Developer's obligations under the City note. Developer pays Bank a fee for the issuance of the letter of credit and issues a note to Bank (the Bank note). The Bank note is secured by a mortgage on the housing project and is guaranteed by FHA. The Bank note and the 1982 issue have different prepayment terms. The City does not reasonably expect to treat prepayments of the Bank note as gross proceeds of the 1982 issue. At the same time or pursuant to a series of related transactions, Bank sells the Bank note to Investor for $9.5 million. Bank invests these monies together with its other funds. In substance, the transaction is a loan by City to Bank, under which Bank enters into a series of transactions that, in effect, result in Bank retaining

$9.5 million in amounts treated as proceeds of the 1994 issue. Those amounts are invested in materially higher yielding investments that provide funds sufficient to equal or exceed the Bank's liability under the letter of credit. Alternatively, the letter of credit is investment property in a sinking fund for the 1994 issue provided by Developer, a substantial beneficiary of the financing. Because, in substance, Developer acquires the $10 million prin cipal amount letter of credit for a fair market value purchase price of $9.5 million, the letter of credit is a materially higher yielding investment. Neither result would change if Developer's obligation under the Bank note is contingent on Bank performing its obligation under the letter of credit. Each characterization causes the bonds to be arbitrage bonds.

Example 2. Bonds outstanding longer than necessary for yield-blending device. (i) Longer bond maturity to create sinking fund. In 1994, Authority issues an advance refunding issue (the refunding issue) to refund a 1982 prior issue (the prior issue). Under current market conditions, Authority will have to invest the refunding escrow at a yield significantly below the yield on the refunding issue. Authority issues its refunding issue with a longer weighted average maturity than otherwise necessary primarily for the purpose of creating a sinking fund for the refunding issue that will be invested in a guaranteed investment contract. The weighted average maturity of the refunding issue is less than 120 percent of the remaining average economic life of the facilities financed with the proceeds of the prior issue. The guaranteed investment contract has a yield that is higher than the yield on the refunding issue. The yield on the refunding escrow blended with the yield on the guaranteed investment contract does not exceed the yield on the issue. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds under section 148(a).

(ii) Refunding of noncallable bonds. The facts are the same as in paragraph (i) of this Example 2 except that instead of structuring the refunding issue to enable it to take advantage of sinking fund investments, Authority will also refund other long-term, non-callable bonds in the same refunding issue. There are no savings attributable to the refunding of the non-callable bonds (e.g., a low-to-high refunding). The Authority invests the portion of the proceeds of the refunding issue allocable to the refunding of the non-callable bonds in the refunding escrow at a yield that is higher than the yield on the refunding issue, based on the relatively long escrow period for this portion of the refunding. The Authority invests the other portion of the proceeds of the refunding issue in the refunding escrow at a yield lower than the yield on the refunding issue. The blended yield on all the investments in the refunding escrow for the prior issues does not exceed the yield on the refunding issue. The portion of the refunding issue used to refund the noncallable bonds, however, was not otherwise necessary and was issued primarily to exploit the difference between taxable and tax-exempt rates for that long portion of the refunding escrow to minimize the effect of lower yielding investments in the other portion of the escrow. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds.

(iii) Governmental purpose. In paragraphs (i) and (ii) of this Example 2, the existence of a governmental purpose for the described financing structures would not change the conclusions unless Authority clearly established that the primary purpose for the use of the particular structure was a bona fide governmental purpose. The fact that each financing structure had the effect of eliminating significant amounts of negative arbitrage is strong evidence of a primary purpose that is not a bona fide governmental purpose. Moreover, in paragraph (i) of this Example 2, the structure of the refunding issue coupled with the acquisition of the guaranteed investment contract to lock in the investment yield associated with the structure is strong evidence of a primary purpose that is not a bona fide governmental purpose.

Example 3. Window refunding. (i) Authority issues its 1994 refunding issue to refund a portion of the principal and interest on its outstanding 1985 issue. The 1994 refunding issue is structured using zero-coupon bonds that pay no interest or principal for the 5-year period following the issue date. The proceeds of the 1994 refunding issue are deposited in a refunding escrow to be used to pay only the interest requirements of the refunded portion of the 1985 issue. Authority enters into a guaranteed investment contract with a financial institution, G, under which G agrees to provide a guaranteed yield on revenues invested by Authority during the 5-year period following the issue date. The guaranteed investment contract has a yield that is no higher than the yield on the refunding issue. The revenues to be invested under this guaranteed investment contract consist of the amounts that Authority otherwise would have used to pay principal and interest on the 1994 refunding issue. The guaranteed investment contract is structured to generate receipts at times and in amounts sufficient to pay the principal and redemption requirements of the refunded portion of the 1985 issue. A principal purpose of these transactions is to avoid transferred proceeds. Authority will continue to invest the unspent proceeds of the 1985 issue that are on deposit in a refunding escrow for its 1982 issue at a yield equal to the yield on the 1985 issue and will not otherwise treat those unspent proceeds as transferred proceeds of the 1994 refunding issue. The 1994 refunding issue is an issue of arbitrage bonds since those bonds involve a transaction or series of transactions that overburdens the market by leaving bonds outstanding longer than is necessary to obtain a material financial advantage based on arbitrage. Specifically, Authority has structured the 1994 refunding issue to make available for the refunding of the 1985 issue replacement proceeds rather than proceeds so that the unspen t proceeds of the 1985 issue will not become transferred proceeds of the 1994 refunding issue.

(ii) The result would be the same in each of the following circumstances:

(A) The facts are the same as in paragraph (i) of this Example 3 except that Authority does not enter into the guaranteed investment contract but instead, as of the issue date of the 1994 refunding issue, reasonably expects that the released revenues will be available for investment until used to pay principal and interest on the 1985 issue.

(B) The facts are the same as in paragraph (i) of this Example 3 except that there are no unspent proceeds of the 1985 issue and Authority invests the released revenues at a yield materially higher than the yield on the 1994 issue.

(C) The facts are the same as in paragraph (i) of this Example 3 except that Authority uses the proceeds of the 1994 issue for capital projects instead of to refund a portion of the 1985 issue.

Example 4. Sale of conduit loan. On January 1, 1994, Authority issues a conduit financing issue (the 1994 conduit financing issue) and uses the proceeds to purchase from City, an unrelated party, a tax-exempt bond of City (the City note). The proceeds of the 1994 conduit financing issue are to be used to advance refund a prior conduit financing issue that was issued in 1988 and used to make a loan to

City. The 1994 conduit financing issue and the City note each have a yield of 8 percent on January 1, 1994. On June 30, 1996, interest rates have decreased and Authority sells the City note to D, a person unrelated to either City or Authority. Based on the sale price of the City note and treating June 30, 1996 as the issue date of the City note, the City note has a 6 percent yield. Authority deposits the proceeds of the sale of the City note into an escrow to redeem the bonds of the 1994 conduit financing issue on January 1, 2001. The escrow is invested in nonpurpose investments having a yield of 8 percent. For purposes of section 149(d), City and Authority are related parties and, therefore, the issue date of the City note is treated as being June 30, 1996. Thus, the City note is an advance refunding of Authority's 1994 conduit financing issue. Interest on the City note is not exempt from Federal income tax from the date it is sold to D under section 149(d), because, by investing the escrow investments at a yield of 8 percent instead of a yield not materially higher than 6 percent, the sale of the City note employs a device to obtain a material financial advantage, based on arbitrage, apart from the savings attributable to lower interest rates. In addition, the City note is not a tax-exempt bond because the note is the second advance refunding of the original bond under section 149(d)(3). The City note also employs an abusive arbitrage device and is an arbitrage bond under section 148.

Example 5. Re-refunding. (i) On January 1, 1984, City issues a tax-exempt issue (the 1984 issue) to finance the cost of constructing a prison. The 1984 issue has a 7 percent yield and a 30-year maturity. The 1984 issue is callable at any time on or after January 1, 1994. On January 1, 1990, City issues a refunding issue (the 1990 issue) to advance refund the 1984 issue. The 1990 issue has an 8 percent yield and a 30-year maturity. The 1990 issue is callable at any time on or after January 1, 2000. The proceeds of the 1990 issue are invested at an 8 percent yield in a refunding escrow for the 1984 issue (the original 1984 escrow) in a manner sufficient to pay debt service on the 1984 issue until maturity (i.e., an escrow to maturity). On January 1, 1994, City issues a refunding issue (the 1994 issue). The 1994 issue has a 6 percent yield and a 30-year maturity. City does not invest the proceeds of the 1994 issue in a refunding escrow for the 1990 issue in a manner sufficient to pay a portion of the debt service until, and redeem a portion of that issue on, January 1, 2000. Instead, City invests those proceeds at a 6 percent yield in a new refunding escrow for a portion of the 1984 issue (the new 1984 escrow) in a manner sufficient to pay debt service on a portion of the 1984 issue until maturity. City also liquidates the investments allocable to the proceeds of the 1990 issue held in the original 1984 escrow and reinvests those proceeds in an escrow to pay a portion of the debt service on the 1990 issue itself until, and redeem a portion of that issue on, January 1, 2000 (the 1990 escrow). The 1994 bonds are arbitrage bonds and employ an abusive device under section 149(d)(4). Although, in form, the proceeds of the 1994 issue are used to pay principal on the 1984 issue, this accounting for the use of the proceeds of the 1994 issue is an unreasonable, inconsistent accounting method under §1.148-6(a). Moreover, since the proceeds of the 1990 issue were set a side in an escrow to be used to retire the 1984 issue, the use of proceeds of the 1994 issue for that same purpose involves a replacement of funds invested in higher yielding investments under section 148(a)(2). Thus, using a reasonable, consistent accounting method and giving effect to the substance of the transaction, the proceeds of the 1994 issue are treated as used to refund the 1990 issue and are allocable to the 1990 escrow. The proceeds of the 1990 issue are treated as used to refund the 1984 issue and are allocable to the investments in the new 1984 escrow. The proceeds of the 1990 issue allocable to the nonpurpose investments in the new 1984 escrow become transferred proceeds of the 1994 issue as principal is paid on the 1990 issue from amounts on deposit in the 1990 escrow. As a result, the yield on nonpurpose investments allocable to the 1994 issue is materially higher than the yield on the 1994 issue, causing the bonds of the 1994 issue to be arbitrage bonds. In addition, the transaction employs a device under section 149(d)(4) to obtain a material financial advantage based on arbitrage, other than savings attributable to lower interest rates.

(ii) The following changes in the facts do not affect the conclusion that the 1994 issue consists of arbitrage bonds-

(1) The 1990 issue is a taxable issue;

(2) The original 1984 escrow is used to pay the 1994 issue (rather than the 1990 issue); or

(3) The 1994 issue is used to retire the 1984 issue within 90 days of January 1, 1994.

(e) Authority of the Commissioner to clearly reflect the economic substance of a transaction. If an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148, the Commissioner may exercise her discretion to depart from the rules of §1.148-1 through §1.148-11 as necessary to clearly reflect the economic substance of the transaction. For this purpose, the Commissioner may recompute yield on an issue or on investments, reallocate payments and receipts on investments, recompute the rebate amount on an issue, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue.

(f) Authority of the Commissioner to require an earlier date for payment of rebate. If the Commissioner determines that an issue is likely to fail to meet the requirements of §1.148-3 and that a failure to serve a notice of demand for payment on the issuer will jeopardize the assessment or collection of tax on interest paid or to be paid on the issue, the date that the Commissioner serves notice on the issuer is treated as a required computation date for payment of rebate for that issue.

(g) Authority of the Commissioner to waive regulatory limitations. Notwithstanding any specific provision in §§1.148-1 through 1.148-11, the Commissioner may prescribe extensions of temporary periods, larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under section 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or other similar circumstances so warrant, consistent with the purposes of section 148.

§1.148-11 Effective dates.

(a) In general. Except as otherwise provided in this section, the provisions of §1.148-1 through §1.148-11 apply to all issues issued after June 30, 1993.

(b) Elective retroactive application in whole-(1) In general. Except as otherwise provided in this section and subject to the applicable effective dates of the corresponding statutory provisions, an issuer may apply the provisions of §1.148-1 through §1.148-11 in whole, but not in part, to any issue that is outstanding on June 30, 1993, and is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954, in lieu of otherwise applicable regulations under those sections.

(2) No elective retroactive application for 18-month spending exception. The provisions of §1.148-7(d) (relating to the 18-month spending exception) may not be applied to any issue issued on or before June 30, 1993.

(c) Elective retroactive application of certain provisions and special rules-(1) In general. An issuer may apply any of the following individual provisions of §1.148-1 through §1.148-11 to outstanding issues issued on or before August 15, 1993, in the indicated manner-

(i) Certain commingled funds. If paragraph (a) of this section applies to an issue, and that issue has a commingled fund to which the provisions of §1.148-6(e)(6) (relating to commingled reserves) apply, that provision may be applied to all issues secured by that commingled reserve.

(ii) Certain applications of the universal cap. The provisions of §1.148-5(c)(3)(i)(F) (and related provisions) may be applied to satisfy the requirements of section 148 (or applicable prior law) if the application of the universal cap results in amounts in a refunding escrow becoming replacement proceeds of an issue issued on or before June 30, 1993.

(2) Certain allocations of multipurpose issues. An allocation of bonds to a refunding purpose under §1.148-9(h) may be adjusted as necessary to reflect allocations made between May 18, 1992, and August 15, 1993, in connection with the issuance of a refunding issue issued during that period if the allocations satisfied the corresponding prior provision of §1.148-11(j)(4) under applicable prior regulations.

(3) Special limitation. The provisions of §1.148-9 apply to issues issued before August 15, 1993, only if the issuer in good faith estimates the present value savings, if any, associated with the effect of the application of that section on refunding escrows, using any reasonable accounting method, and applies those savings, if any, to redeem outstanding tax-exempt bonds of the applicable issue at the earliest possible date on which those bonds may be redeemed or otherwise retired. These savings are not reduced to take into account any administrative costs associated with applying these provisions retroactively.

(d) Transition rule excepting certain state guarantee funds from the definition of replacement proceeds-(1) Certain perpetual trust funds. A guarantee by a fund created and controlled by a State and established pursuant to its constitution does not cause the amounts in the fund to be pledged funds treated as replacement proceeds if-

(i) Substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts, and bequests;

(ii) The corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (designated functions) carried on by political subdivisions with general taxing powers;

(iii) Substantially all of the available income of the fund is required to be applied annually to support designated functions;

(iv) The issue guaranteed consists of general obligations that are not private activity bonds substantially all of the proceeds of which are to be used for designated functions;

(v) The fund satisfied each of the requirements of paragraphs (d)(1)(i) through (d)(1)(iii) of this section on August 16, 1986; and

(vi) The guarantee is not attributable to a deposit to the fund made after May 14, 1989, unless-

(A) The deposit is attributable to the sale or other disposition of fund assets; or

(B) Prior to the deposit, the outstanding amount of the bonds guaranteed by the fund did not exceed 250 percent of the lower of the cost or fair market value of the fund.

(2) Permanent University Fund. Replacement proceeds do not include amounts allocable to investments of the fund described in section 648 of Public Law 98-369.

(e) Transition rule regarding special allowance payments. Section 1.148-5(b)(5) applies to any bond issued after January 5, 1990, except a bond issued exclusively to refund a bond issued before January 6, 1990, if the amount of the refunding bond does not exceed 101 percent of the amount of the refunded bond, and the maturity date of the refunding bond is not later than the date that is 17 years after the date on which the refunded bond was issued (or, in the case of a series of refundings, the date on which the original bond was issued).

(f) Transition rule regarding applicability of yield reduction rule. Section 1.148-5(c) applies to nonpurpose investments allocable to replacement proceeds of an issue that are held in a reserve or replacement fund to the extent that-

(1) Amounts must be paid into the fund under a constitutional provision, statute, or ordinance adopted before May 3, 1978;

(2) Under that provision, amounts paid into the fund (and investment earnings thereon) can be used only to pay debt service on the issues; and

(3) The size of the payments made into the fund is independent of the size of the outstanding issues or the debt service thereon.

(g) Extension of due date for rebate payments. Payments of rebate under section 148(f) that are otherwise due after June 30, 1993, and before September 1, 1993, may be paid by September 1, 1993.

(h) Elective application of existing regulations. For an issue issued after June 30, 1993 and before August 15, 1993, an issuer may apply the provisions of T.D. 7627, sections 1.103-13, 1.103-14, 1.103-15, 1979-2 C.B. 45, (see §601.601(d)(2)(ii)(b)) of this chapter, as amended by T.D. 8418, 1992-1 C.B. 29; T.D. 8345, section 1.103-13T, 1991-1 C.B. 33; and T.D. 8418, sections 1.148-0 through 1.148-11, 1.149(d)-1 and 1.150-1, 1992-1 C.B. 29, in whole, but not in part, in lieu of applying these regulations under paragraph (a) of this section, without regard to §1.148-0(b)(2)(ii)(D) of those provisions.

§§1.148-12T and 1.148-13T (Removed)

Par. 5a. Sections 1.148-12T and 1.148-13T are removed.

Par. 6. Section 1.149(b)-1 is added to read as follows:

§1.149(b)-1 Federally guaranteed bonds.

(a) General rule. Under section 149(b) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue that is federally guaranteed.

(b) Exceptions. Pursuant to section 149(b)(3)(B), section 149(b)(1) and paragraph (a) of this section do not apply to-

(1) Investments in obligations issued pursuant to §21B(d)(3) of the Federal Home Loan Bank Act, as amended by §511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision; or

(2) Any investments that are held in a refunding escrow (as defined in §1.148-1).

(c) Effective date. This section applies to investments made after June 30, 1993.

§1.149(b)(3)-1T (Removed)

Par. 7. Section §1.149(b)(3)-1T is removed.

Par. 8. Section 1.149(d)-1 is revised to read as follows:

§1.149(d)-1 Limitations on advance refundings.

(a) General rule. Under section 149(d) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in paragraphs (2), (3), or (4) of section 149(d).

(b) Advance refunding issues that employ abusive devices-(1) In general. An advance refunding issue employs an abusive device and is described in section 149(d)(4) if the issue violates any of the anti-abuse rules under §1.148-10.

(2) Failure to pay required rebate. An advance refunding issue is described in section 149(d)(4) if the issue fails to meet the requirements of §1.148-3. This paragraph (b)(2) applies to any advance refunding issue issued after August 31, 1986.

(3) Mixed escrows invested in tax-exempt bonds. An advance refunding issue is described in section 149(d)(4) if-

(i) Any of the proceeds of the issue are invested in a refunding escrow in which a portion of the proceeds are invested in tax-exempt bonds and a portion of the proceeds are invested in nonpurpose investments;

(ii) The yield on the tax-exempt bonds in the refunding escrow exceeds the yield on the issue;

(iii) The yield on all the investments (including investment property and tax-exempt bonds) in the refunding escrow exceeds the yield on the issue; and

(iv) The weighted average maturity of the tax-exempt bonds in the refunding escrow is more than 25 percent greater or less than the weighted average maturity of the nonpurpose investments in the refunding escrow, and the weighted average maturity of nonpurpose investments in the refunding escrow is greater than 60 days.

(4) Tax-exempt conduit loans. For purposes of applying section 149(d) to a conduit financing issue that finances any conduit loan that is a tax-exempt bond, the actual issuer of a conduit financing issue and the conduit borrower of that conduit financing issue are treated as related parties. Thus, the issue date of the conduit loan does not occur prior to the date on which the actual issuer of the conduit financing issue sells, exchanges, or otherwise disposes of that conduit loan, and the use of the proceeds of the disposition to pay debt service on the conduit financing issue causes the conduit loan to be a refunding issue. See §1.148-10(d), Example 4.

(c) Unrefunded debt service remains eligible for future advance refunding. For purposes of section 149(d)(3)(A)(i), any principal or interest on a prior issue that has not been paid or provided for by any advance refunding issue is treated as not having been advance refunded.

(d) Application of arbitrage regulations-(1) Application of multipurpose issue rules. For purposes of sections 149(d)(2) and (3)(A)(i), (ii), and (iii), the provisions of the multipurpose issue rule in §1.148-9(h) apply.

(2) General mixed escrow rules. For purposes of section 149(d), the provisions of §1.148-9(c) (relating to mixed escrows) apply, except that those provisions do not apply for purposes of section 149(d)(2) and (d)(3)(A) (i) and (ii) to amounts that were not gross proceeds of the prior issue before the issue date of the refunding issue.

(3) Temporary periods and minor portions. Section 1.148-9(d) and (f) contains rules applicable to temporary periods and minor portions for advance refunding issues.

(4) Definitions. Section 1.148-1 applies for purposes of section 149(d).

(e) Taxable refundings-(1) In general. Except as provided in paragraph (e)(2) of this section, for purposes of section 149(d)(3)(A)(i), an advance refunding issue the interest on which is not excludable from gross income under section 103(a) (i.e., a taxable advance refunding issue) is not taken into account. In addition, for this purpose, an advance refunding of a taxable issue is not taken into account unless the taxable issue is a conduit loan of a tax-exempt conduit financing issue.

(2) Use to avoid section 149(d)(3)(A)(i). A taxable issue is taken into account under section 149(d)(3)(A)(i) if it is issued to avoid the limitations of that section. For example, in the case of a refunding of a tax-exempt issue with a taxable advance refunding issue that is, in turn, currently refunded with a tax-exempt issue, the taxable advance refunding issue is taken into account under section 149(d)(3)(A)(i) if the two tax-exempt issues are outstanding concurrently for more than 90 days.

(f) Redemption at first call date-(1) General rule. Under sections 149(d)(3)(A) (ii) and (iii) (the first call requirement), bonds refunded by an advance refunding must be redeemed on their first call date if the savings test under section 149(d)(3)(B)(i) (the savings test) is satisfied. The savings test is satisfied if the issuer may realize present value debt service savings (determined without regard to administrative expenses) in connection with the issue of which the refunding bond is a part.

(2) First call date. First call date means the earliest date on which a bond may be redeemed (or, if issued before 1986, on the earliest date on which that bond may be redeemed at a redemption price not in excess of 103 percent of par). If, however, the savings test is not met with respect to the date described in the preceding sentence (i.e., there are no present value savings if the refunded bonds are retired on that date), the first call date is the first date thereafter on which the bonds can be redeemed and on which the savings test is met.

(3) Savings test. Except as provided below, the multipurpose issue allocation rules apply for purposes of the savings test. The savings test is satisfied and the first call requirement applies to a bond if the refunding of that bond increases the aggregate present value debt service savings on the entire refunding issue when compared with the aggregate present value debt service savings if that bond were not refunded.

(g) Effective date-(1) In general. Except as provided in paragraph (g)(2) of this section, this section applies to bonds issued after June 30, 1993, to which §§1.148-1 through 1.148-11 apply, including conduit loans that are treated as issued after June 30, 1993, under paragraph (b)(4) of this section. In addition, this section applies to any issue to which the election described in §1.148-11(b)(1) is made.

(2) Special effective date for paragraph (b)(3). Paragraph (b)(3) of this section applies to any advance refunding issue issued after May 28, 1991.

Par. 9. Section 1.149(g)-1 is added to read as follows:

§1.149(g)-1 Hedge bonds.

(a) Certain definitions. Except as otherwise provided, the definitions set forth in §1.148-1 apply for purposes of section 149(g) and this section. In addition, the following terms have the following meanings:

Reasonable expectations means reasonable expectations (as defined in §1.148-1), as modified to take into account the provisions of section 149(f)(2)(B).

Spendable proceeds means net sale proceeds (as defined in §1.148-1).

(b) Applicability of arbitrage allocation and accounting rules. Section 1.148-6 applies for purposes of section 149(g), except that an expenditure that results in the creation of replacement proceeds (other than amounts in a bona fide debt service fund or a reasonably required reserve or replacement fund) is not an expenditure for purposes of section 149(g).

(c) Refundings-(1) Investment in tax-exempt bonds. A bond issued to refund a bond that is a tax-exempt bond by virtue of the rule in section 149(g)(3)(B) is not a tax-exempt bond unless the gross proceeds of that refunding bond (other than proceeds in a refunding escrow for the refunded bond) satisfy the requirements of section 149(g)(3)(B).

(2) Anti-abuse rule. A refunding bond is treated as a hedge bond unless there is a significant governmental purpose for the issuance of that bond (e.g., an advance refunding bond issued to realize debt service savings or to relieve the issuer of significantly burdensome document provisions, but not to otherwise hedge against future increases in interest rates).

(d) Effective date. This section applies to bonds issued after June 30, 1993 to which §§1.148-1 through 1.148-11 apply. In addition, this section applies to any issue to which the election described in §1.148-11(b)(1) is made.

Par. 10. Section 1.150-1 is revised to read as follows:

§1.150-1 Definitions.

(a) Scope and effective date-(1) In general. Except as otherwise provided, the definitions in this section apply for all purposes of sections 103 and 141 through 150.

(2) Effective date. This section applies to issues issued after June 30, 1993 to which §§1.148-1 through 1.148-11 apply. In addition, this section (other than paragraph (c)(3) of this section) applies to any issue to which the election described in §1.148-11(b)(1) is made.

(b) Certain general definitions. The following definitions apply:

Bond means any obligation of a State or political subdivision thereof under section 103(c)(1).

Capital expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under §1.150-2(c)) under general Federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property. Future changes in law do not affect whether an expenditure is a capital expenditure.

Conduit borrower means the obligor on a purpose investment (as defined in §1.148-1). For example, if an issuer invests proceeds in a purpose investment in the form of a loan, lease, installment sale obligation, or similar obligation to another entity and the obligor uses the proceeds to carry out the governmental purpose of the issue, the obligor is a conduit borrower.

Conduit financing issue means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

Conduit loan means a purpose investment (as defined in §1.148-1).

Governmental bond means any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds.

Issuance costs means costs to the extent incurred in connection with, and allocable to, the issuance of an issue within the meaning of section 147(g). For example, issuance costs include the following costs but only to the extent incurred in connection with, and allocable to, the borrowing: underwriters' spread; counsel fees; financial advisory fees; rating agency fees; trustee fees; paying agent fees; bond registrar, certification, and authentication fees; accounting fees; printing costs for bonds and offering documents; public approval process costs; engineering and feasibility study costs; guarantee fees, other than for qualified guarantees (as defined in §1.148-4(f)); and similar costs.

Issue date means, in reference to an issue, the first date on which the issuer receives the purchase price in exchange for delivery of the evidence of indebtedness representing any bond included in the issue. Issue date means, in reference to a bond, the date on which the issuer receives the purchase price in exchange for that bond. In no event is the issue date earlier than the first day on which interest begins to accrue on the bond or bonds for Federal income tax purposes.

Obligation means any valid evidence of indebtedness under general Federal income tax principles.

Pooled financing issue means an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to finance a single capital project.

Private activity bond means a private activity bond (as defined in section 141).

Qualified mortgage loan means a mortgage loan with respect to an owner-occupied residence acquired with the proceeds of an obligation described in section 143(a)(1) or 143(b) (or applicable prior law).

Qualified student loan means a student loan acquired with the proceeds of an obligation described in section 144(b)(1).

Related party means, in reference to a governmental unit or a 501(c)(3) organization, any member of the same controlled group, and, in reference to any person that is not a governmental unit or 501(c)(3) organization, a related person (as defined in section 144(a)(3)).

Taxable bond means any obligation the interest on which is not excludable from gross income under section 103.

Tax-exempt bond means any bond the interest on which is excludable from gross income under section 103(a). Tax-exempt bond includes an interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103(a).

Working capital expenditure means any cost that is not a capital expenditure. Generally, current operating expenses are working capital expenditures.

(c) Definition of issue-(1) In general. The provisions of this paragraph (c) apply for all purposes of sections 103 and 141 through 150. Except as otherwise provided in this paragraph (c), two or more bonds are treated as part of the same issue if all of the following factors are present:

(i) Sold at substantially the same time. The bonds are sold at substantially the same time. Bonds are treated and sold at substantially the same time if they are sold less than 15 days apart. For this purpose only, a variable yield bond is treated and sold on its issue date.

(ii) Sold pursuant to the same plan of financing. The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally-

(A) Bonds to finance a single facility or related facilities are part of the same plan of financing;

(B) Short-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing; and

(C) Certificates of participation in a lease and general obligation bonds secured by tax revenues are not part of the same plan of financing.

(iii) Payable from same source of funds. The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from unrelated parties.

(2) Exception for taxable bonds. Taxable bonds and tax-exempt bonds are not part of the same issue under this paragraph (c). The issuance of tax-exempt bonds in a transaction (or series of related transactions) that includes taxable bonds, however, may constitute an abusive arbitrage device under §1.148-10(a) or a device to avoid other limitations in sections 103 and 141 through 150 (for example, structures involving windows or unreasonable allocations of bonds).

(3) Exception for certain bonds financing separate purposes-(i) In general. Bonds may be treated as part of separate issues if the requirements of this paragraph (c)(3) are satisfied. Each of these separate issues must finance a separate purpose (e.g., refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose). Each of these separate issues independently must be a tax-exempt bond (e.g., a governmental bond or a qualified mortgage bond). The aggregate proceeds, investments, and bonds in such a transaction must be allocated between each of the separate issues using a reasonable, consistently applied allocation method. If any separate issue consists of refunding bonds, the allocation rules in §1.148-9(h) must be satisfied. An allocation is not reasonable if it achieves more favorable results under sections 103 and 141 to 150 than could be achieved with actual separate issues. All allocations under this paragraph (c)(3) must be made in writing on or before the issue date.

(ii) Exceptions. This paragraph (c)(3) does not apply for purposes of sections 141(b)(5), 141(c)(1), 141(d)(1), 144(a), 148, 149(d), and 149(g).

(4) Special rules for draw-down loans and commercial paper-(i) Draw-down loans. Bonds issued pursuant to a draw-down loan are treated as part of a single issue. The issue date of that issue is the first date on which the aggregate draws under the loan exceed the lesser of $50,000 or 5 percent of the issue price.

(ii) Commercial paper-(A) In general. Short-term bonds having a maturity of 270 days or less (commercial paper) issued pursuant to the same commercial paper program may be treated as part of a single issue, the issue date of which is the first date the aggregate amount of commercial paper issued under the program exceeds the lesser of $50,000 or 5 percent of the aggregate issue price of the commercial paper in the program. A commercial paper program is a program to issue commercial paper to finance or refinance the same governmental purpose pursuant to a single master legal document. Commercial paper is not part of the same commercial paper program unless issued during an 18-month period, beginning on the deemed issue date. In addition, commercial paper issued after the end of this 18-month period may be treated as part of the program to the extent issued to refund commercial paper that is part of the program, but only to the extent that-

(1) There is no increase in the principal amount outstanding; and

(2) The program does not have a term in excess of-

(i) 30 years; or

(ii) The period reasonably necessary for the governmental purposes of the program.

(B) Safe harbor. The requirement of paragraph (c)(4)(ii)(A)(2) of this section is treated as satisfied if the weighted average maturity of the issue does not exceed 120 percent of the weighted average expected economic life of the property financed by the issue.

(5) Anti-abuse rule. In order to prevent the avoidance of sections 103 and 141 through 150 and the general purposes thereof, the Commissioner may treat bonds

as part of the same issue or as part of separate issues to clearly reflect the economic substance of a transaction.

(d) Definition of refunding issue and related definitions-(1) General definition of refunding issue. Refunding issue means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (a prior issue, as more particularly defined in paragraph (d)(5) of this section), including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any, properly allocable to that refunding issue.

(2) Exceptions and special rules. For purposes of paragraph (d)(1) of this section, the following exceptions and special rules apply-

(i) Payment of certain interest. An issue is not a refunding issue if the only principal and interest that is paid with proceeds of the issue (determined without regard to the multipurpose issue rules of §1.148-9(h)) is interest on another issue that-

(A) Accrues on the other issue during a one-year period including the issue date of the issue that finances the interest;

(B) Is a capital expenditure; or

(C) Is a working capital expenditure to which the de minimis rule of §1.148-6(d)(3)(ii)(A) applies.

(ii) Certain issues with different obligors-(A) In general. An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (d)(2)(ii)(B) of this section) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue.

(B) Definition of obligor. The obligor of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in §1.148-1) does not include the ultimate recipient of the loan (e.g., the homeowner, the student).

(iii) Certain special rules for purpose investments. For purposes of this paragraph (d), the following special rules apply:

(A) Refunding of a conduit financing issue by a conduit loan refunding issue. Except as provided in paragraph (d)(2)(iii)(B) of this section, the use of the proceeds of an issue that is used to refund an obligation that is a purpose investment (a conduit refunding issue) by the actual issuer of the conduit financing issue determines whether the conduit refunding issue is a refunding of the conduit financing issue (in addition to a refunding of the obligation that is the purpose investment).

(B) Recycling of certain payments under purpose investments. A conduit refunding issue is not a refunding of a conduit financing issue to the extent that the actual issuer of the conduit financing issue reasonably expects as of the date of receipt of the proceeds of the conduit refunding issue to use those amounts within 6 months (or, if greater, during the applicable temporary period for those amounts under section 148(c) or under applicable prior law) to acquire a new purpose investment. Any new purpose investment is treated as made from the proceeds of the conduit financing issue.

(C) Application to tax-exempt loans. For purposes of this paragraph (d), obligations that would be purpose investments (absent section 148(b)(3)(A)) are treated as purpose investments.

(iv) Substance of transaction controls. In the absence of other applicable controlling rules under this paragraph (d), the determination of whether an issue is a refunding issue is based on the substance of the transaction in light of all the facts and circumstances.

(v) Certain integrated transactions in connection with asset acquisition not treated as refunding issues. If, within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), the assumed issue is refinanced, the refinancing issue is not treated as a refunding issue.

(3) Current refunding issue. Current refunding issue means:

(i) Except as provided in paragraph (d)(3)(ii) of this section, a refunding issue that is issued not more than 90 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; and

(ii) In the case of a refunding issue issued before 1986-

(A) A refunding issue that is issued not more than 180 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; or

(B) A refunding issue if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(4) Advance refunding issue. Advance refunding issue means a refunding issue that is not a current refunding issue.

(5) Prior issue. Prior issue means an issue of obligations all or a portion of the principal, interest, or call premium on which is paid or provided for with proceeds of a refunding issue. A prior issue may be issued before, at the same time as, or after a refunding issue. If the refunded and unrefunded portions of a prior issue are treated as separate issues under §1.148-9(i), for the purposes for which that section applies, except to the extent that the context clearly requires otherwise, references to a prior issue refer only to the refunded portion of that prior issue.

(e) Controlled group means a group of entities controlled directly or indirectly by the same entity or group of entities within the meaning of this paragraph (e).

(1) Direct control. The determination of direct control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the controlling entity) generally controls another entity or group of entities (the controlled entity) for purposes of this paragraph if the controlling entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial-

(i) The right or power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity; or

(ii) The right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

(2) Indirect control. If a controlling entity controls a controlled entity under the test in paragraph (e)(1) of this section, then the controlling entity also controls all entities controlled, directly or indirectly, by the controlled entity or entities.

(3) Exception for general purpose governmental entities. An entity is not a controlled entity under this paragraph (e) f the entity possesses substantial taxing, eminent domain, and police powers. For example, a city possessing substantial amounts of each of these sovereign powers is not a controlled entity of the state.

Par. 11. Section 1.150-2 is added to read as follows:

§1.150-2 Proceeds of bonds used for reimbursement.

(a) Table of contents. This table of contents contains a listing of the headings contained in §1.150-2.

(b) Scope. This section applies to reimbursement bonds (as defined in paragraph (c) of this section) for all purposes of sections 103 and 141 to 150.

(c) Definitions. The following definitions apply:

Issuer means-

(1) For any private activity bond (excluding a qualified 501(c)(3) bond, qualified student loan bond, qualified mortgage bond, or qualified veterans' mortgage bond), the entity that actually issues the reimbursement bond; and

(2) For any bond not described in paragraph (1) of this definition, either the entity that actually issues the reimbursement bond or, to the extent that the reimbursement bond proceeds are to be loaned to a conduit borrower, that conduit borrower.

Official intent means an issuer's declaration of intent to reimburse an original expenditure with proceeds of an obligation.

Original expenditure means an expenditure for a governmental purpose that is originally paid from a source other than a reimbursement bond.

Placed in service means, with respect to a facility, the date on which, based on all the facts and circumstances-

(1) The facility has reached a degree of completion which would permit its operation at substantially its design level; and

(2) The facility is, in fact, in operation at such level.

Reimbursement allocation means an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an original expenditure. An allocation made within 30 days after the issue date of a reimbursement bond may be treated as made on the issue date.

Reimbursement bond means the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date.

(d) General operating rules for reimbursement expenditures. Except as otherwise provided, a reimbursement allocation is treated as an expenditure of proceeds of a reimbursement bond for the governmental purpose of the original expenditure on the date of the reimbursement allocation only if:

(1) Official intent. Not later than 60 days after payment of the original expenditure, the issuer adopts an official intent for the original expenditure that satisfies paragraph (e) of this section.

(2) Reimbursement period-(i) In general. The reimbursement allocation is made not later than 18 months after the later of-

(A) The date the original expenditure is paid; or

(B) The date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid.

(ii) Special rule for small issuers. In applying paragraph (d)(2)(i) of this section to an issue that satisfies section 148(f)(4)(D)(i) (I) through (IV), the "18 month" limitation is changed to "3 years" and the "3-year" maximum reimbursement period is disregarded.

(iii) Special rule for long-term construction projects. In applying paragraph (d)(2)(i) to a construction project for which both the issuer and a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project, the maximum reimbursement period is changed from "3 years" to "5 years."

(3) Nature of expenditure. The original expenditure is a capital expenditure, a cost of issuance for a bond, an expenditure described in §1.148-6(d)(3)(ii)(B) (relating to certain extraordinary working capital items), a grant (as defined in §1.148-6(d)(4)), a qualified student loan, a qualified mortgage loan, or a qualified veterans' mortgage loan.

(e) Official intent rules. An official intent satisfies this paragraph (e) if:

(1) Form of official intent. The official intent is made in any reasonable form, including issuer resolution, action by an appropriate representative of the issuer (e.g., a person authorized or designated to declare official intent on behalf of the issuer), or specific legislative authorization for the issuance of obligations for a particular project.

(2) Project description in official intent-(i) In general. The official intent generally describes the project for which the original expenditure is paid and states the maximum principal amount of obligations expected to be issued for the project. A project includes any property, project, or program (e.g., highway capital improvement program, hospital equipment acquisition, or school building renovation).

(ii) Fund accounting. A project description is sufficient if it identifies, by name and functional purpose, the fund or account from which the original expenditure is paid (e.g., parks and recreation fund-recreational facility capital improvement program).

(iii) Reasonable deviations in project description. Deviations between a project described in an official intent and the actual project financed with reimbursement bonds do not invalidate the official intent to the extent that the actual project is reasonably related in function to the described project. For example, hospital equipment is a reasonable deviation from hospital building improvements. In contrast, a city office building rehabilitation is not a reasonable deviation from highway improvements.

(3) Reasonableness of official intent. On the date of the declaration, the issuer must have a reasonable expectation (as defined in §1.148-1(b)) that it will reimburse the original expenditure with proceeds of an obligation. Official intents declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project (e.g., blanket declarations) are not reasonable. Similarly, a pattern of failure to reimburse actual original expenditures covered by official intents (other than in extraordinary circumstances) is evidence of unreasonableness. An official intent declared pursuant to a specific legislative authorization is rebuttably presumed to satisfy this paragraph (e)(3).

(f) Exceptions to general operating rules-(1) De minimis exception. Paragraphs (d)(1) and (d)(2) of this section do not apply to costs of issuance of any bond or to an amount not in excess of the lesser of $100,000 or 5 percent of the proceeds of the issue.

(2) Preliminary expenditures exception. Paragraphs (d)(1) and (d)(2) of this section do not apply to any preliminary expenditures, up to an amount not in excess of 20 percent of the aggregate issue price of the issue or issues that finance or are reasonably expected by the issuer to finance the project for which the preliminary expenditures were incurred. Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incident to commencement of construction.

(g) Special rules on refundings-(1) In general-once financed, not reimbursed. Except as provided in paragraph (g)(2) of this section, paragraph (d) of this section does not apply to an allocation to pay principal or interest on an obligation to reimburse an original expenditure paid by another obligation. Instead, such an allocation is analyzed under rules on refunding issues. See §1.148-9.

(2) Certain proceeds of prior issue used for reimbursement treated as unspent. In the case of a refunding issue (or series of refunding issues), proceeds of a prior issue purportedly used to reimburse original expenditures are treated as unspent proceeds of the prior issue unless the purported reimbursement was a valid expenditure under applicable law on reimbursement expenditures on the issue date of the prior issue.

(h) Anti-abuse rules-(1) General rule. A reimbursement allocation is not an expenditure of proceeds of an issue under this section if the allocation employs an abusive arbitrage device under §1.148-10 to avoid the arbitrage restrictions or to avoid the restrictions under sections 142 through 147.

(2) One-year step transaction rule-(i) Creation of replacement proceeds. A purported reimbursement allocation is invalid and thus is not an expenditure of proceeds of an issue if, within 1 year after the allocation, funds corresponding to the proceeds of a reimbursement bond for which a reimbursement allocation was made are used in a manner that results in the creation of replacement proceeds (as defined in §1.148-1) of that issue or another issue. The preceding sentence does not apply to amounts deposited in a bona fide debt service fund (as defined in §1.148-1).

(ii) Example. The provisions of paragraph (h)(2)(i) of this section are illustrated by the following example.

Example. On January 1, 1994, County A issues an issue of 7 percent tax-exempt bonds (the 1994 issue) and makes a purported reimbursement allocation to reimburse an original expenditure for specified capital improvements. A immediately deposits funds corresponding to the proceeds subject to the reimbursement allocation in an escrow fund to provide for payment of principal and interest on its outstanding 1991 issue of 9 percent tax-exempt bonds (the prior issue). The use of amounts corresponding to the proceeds of the reimbursement bonds to create a sinking fund for another issue within 1 year after the purported reimbursement allocation invalidates the reimbursement allocation. The proceeds retain their character as unspent proceeds of the 7 percent issue upon deposit in the escrow fund. Accordingly, the proceeds are subject to the 7 percent yield restriction of the 1994 issue instead of the 9 percent yield restriction of the prior issue.

(i) Authority of the Commissioner to prescribe rules. The Commissioner may by revenue ruling or revenue procedure (see §601.601(d)(2)(ii)(b) of this chapter) prescribe rules for the expenditure of proceeds of reimbursement bonds in circumstances that do not otherwise satisfy this section.

(j) Effective date-(1) In general. The provisions of this section apply to all allocations of proceeds of reimbursement bonds issued after June 30, 1993.

(2) Transitional rules-(i) Official intent. An official intent is treated as satisfying the official intent requirement of paragraph (d)(1) of this section if it-

(A) Satisfied the applicable provisions of §1.103-8(a)(5) as in effect prior to July 1, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made prior to that date, or

(B) Satisfied the applicable provisions of §1.103-18 as in effect between January 27, 1992, and June 30, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made during that period.

(ii) Certain expenditures of private activity bonds. For any expenditure that was originally paid prior to August 15, 1993, and that would have qualified for expenditure by reimbursement from the proceeds of a private activity bond under T.D. 7199, section 1.103-8(a)(5), 1972-2 C.B. 45 (see §601.601(d)(2)(ii)(b)) of this chapter, the requirements of that section may be applied in lieu of this section.

PART 6a-TEMPORARY REGULATIONS UNDER TITLE II OF THE OMNIBUS RECONCILIATION ACT OF 1980

Par. 12. The authority for part 6a is revised to read as follows:

Authority:

26 U.S.C. 7805.

Sections 6a.103A-2(k), (l), and (m) also issued under 26 U.S.C. 103A(j) (3), (4), and (5).

Par. 13. Section 6a.103A-2 is amended by adding a new paragraph (i)(3)(v) to read as follows:

§6a.103A-2 Qualified mortgage bond.

(i)

(3)

(v) Bonds issued after June 30, 1993. Section 1.148-2(f)(2)(iv) applies to bonds issued after June 30, 1993, in lieu of this paragraph (i)(3).

PART 602-OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 14. The authority citation for part 602 continues to read as follows:

Authority:

26 U.S.C. 7805.

Par. 15. Section 602.101(c) is amended by adding the following entries in numerical order to the table to read as follows:

§602.101 OMB Control Numbers.

(c) -- CFR part or section where identified and described Current OMB control number -- * * * * *

CFR part or section where identified and described	Current OMB control number
1.148-2	1545-1347
1.148-3	1545-1347
1.148-4	1545-1347
1.148-7	1545-1347
1.148-11	1545-1347

* * * * * --

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved: June 4, 1993.

Leslie Samuels,

Assistant Secretary of the Treasury (Tax Policy).